Market Update

February 11, 2020

Update on the Coronavirus and Recent Economic Data

Highlights

- Heading into 2020, there were some early signs of improvement in global growth.
- The coronavirus was not on the radar of most investors heading into 2020.
- Fourth quarter GDP registered 2.1% while full year 2019 GDP was 2.3% (versus 2.9% in 2018).
- The coronavirus is likely to impact global economic growth over the next several months..how much is still unknown.
- The Federal Reserve Bank has indicated that they would like to keep rates on hold this year.
- Recent economic data including employment, manufacturing and corporate profits have come in better than expected.
- While the coronavirus remains front page news, a soft landing and not a recession remains our base case for now.
- Risks include rising debt levels, election year politics and geopolitical events around the world.

Heading into this year, there were some early indications that the global economy was starting to turn in a more positive direction. We saw modest signs of improvement in global manufacturing, trade, commodities along with somewhat higher interest rates. A Phase One trade deal with China along with the signing of the USMCA trade deal with Canada and Mexico also created a more positive backdrop for global growth. Some of these were definitely tentative signs, but along with multiple rate cuts by central banks around the world over the past several quarters, there was reason to believe that global growth was set to start improving over the next 6-12 months.

The coronavirus is not something that was on the radar for most investors heading into 2020. Today, it is front page news and represents an important health scare that is creating a headwind for global growth in early 2020. Chinese authorities have moved aggressively to deal with the spread of the virus through quarantines (to prevent further spread of the virus) and liquidity measures (to help stabilize financial markets). However, media reports indicate the number of people infected and the death toll in mainland China have continued to rise in recent days. The important question for the markets is when does the growth rate of new cases start to slow down and ultimately reverse?

As we wrote a couple of weeks ago, history indicates that if the virus can be controlled within a reasonable amount of time (note: there have been news reports that various firms around the world are currently working on vaccines to treat the virus), consumer and business activity should resume and that we should experience a rebound in global economic activity. However, until we get from point A to point B, we recognize that the next few weeks could be a little bumpy.

Fourth quarter, 2019 U.S. GDP was also released last week and registered 2.1% (in line with estimates) and full year 2019 GDP rose 2.3% which compares with a growth rate of 2.9% the prior year. Looking ahead, changes in the price of copper, oil and bond yields should help shed some light on where the economy and financial markets may go from here. The near-term hit to the U.S. (and global) economy appears likely to be transitory. What we don't know at this point is the depth of any potential economic slowdown and how long it may last.

GDP here in the U.S. and around the world appears likely to slow somewhat in early 2020 as a result of the coronavirus outbreak in China. According to estimates from Goldman Sachs, first quarter GDP in China, the world's second largest economy, could be reduced by 2%. This may have ripple effects across a number of other countries around the world including Germany, Taiwan, South Korea and the United States, for example.

Morgan Stanley believes that if business activity in China resumes in the next week or so, global GDP growth will only slow 15 to 30 basis points (.15 - .30%) this quarter. If it takes somewhat longer for economic growth to resume then global GDP growth may slow 35 to 50 basis points and if the coronavirus does not peak until April, then first quarter global GDP may be reduced by 50 to 75 basis points. Following the slowdowns cited above, economic growth is forecast to rebound and recapture lost economic output.

The Federal Reserve Bank has indicated that they want to pause in 2020 and keep rates unchanged (thus leaving some ammunition if it is really needed in the future). We continue to watch a number of leading indicators i.e. the Conference Board's Leading Economic Index (treading water at elevated levels), credit spreads (still well behaved), weekly jobless claims (remaining near 50 year lows), the Fed's Quarterly Senior Lending Survey (holding at pretty healthy levels) and housing starts (at cycle highs). One index that could change the Fed's behavior is the yield curve (i.e. the spread between 3-month U.S. Treasury Bill and 10 Year U.S. Treasury Note Yields). If this spread were to turn negative again for a sustained period of time, the central bank could cut rates again this year and take out an insurance policy (even though the Fed hopes to not have to use it).

We wanted to highlight a few positive economic data reports that were released last week. First, monthly payrolls increased a healthy 225,000 last month compared with estimates of an increase of 165,000, weekly jobless claims remained low at 202,000 last week and wage growth was up +0.2% month over month (3.1% year over year). Wage growth has remained positive over the past several years but has not been as strong we would have expected given the multi-decade low unemployment rate in the economy. Importantly, wage growth remains above the rate of inflation (currently 1.6% as measured by the Bureau of Labor Statistics), meaning consumer buying power continues to be positive.

Within last week's monthly employment report, manufacturing jobs declined 12,000 highlighting continued weakness from the 2019 slowdown in business and capital spending. One other highlight from last week's jobs report is that the unemployment rate rose 0.1% point to 3.6%. On the surface this is clearly not a positive thing. However, the slight rise in the unemployment rate is largely due to the fact that more people entered the workforce last month in search of jobs (i.e. the labor force participation rose a healthy 0.2% points last month to 63.4%). As these new entrants into the workforce (hopefully) start to find jobs, this should lead to a rise in income and increased spending which should help support the economy in the months ahead.

Last week, the monthly ISM Manufacturing report was also released. The manufacturing index surprisingly rose to a 6-month high of 50.9 (compared with a reading of 47.8 the prior month). As a reminder, a reading above 50 indicates expansion while a reading below 50 indicates contraction. Within the ISM Manufacturing report, new orders rose to an 8-month high of 52.0, production rebounded to a 10-month high of 54.3 and employment rose modestly to a reading of 46.6. The rebound in the manufacturing index last month was certainly welcome news and could signal the start of a rebound in capital equipment spending similar to past periods during the current expansion (i.e. in 2011/2012 and 2015 / 2016). However, we would not be surprised to see somewhat weaker data in early 2020 (due to the effects of the coronavirus on global growth) before things truly start to improve on a more sustained basis later this year.

Turning to corporate profits, as of February 7th, 64% of companies in the S & P 500 have now reported fourth quarter results. Earnings per share (EPS) for Q4, 2019 was forecast to be -1.7% as of 12/31/19 but are now forecast to be positive 0.7%. If the final number remains positive, this would break a streak of three quarters of negative year over year EPS growth dating back to early 2019. Looking ahead, EPS for the four quarters of 2020 are currently forecast to be +2.5%, +5.0%, +9.8% and + 11.9% on a year over year basis. For full year 2020, EPS is currently forecast to rise 8.3% which is a positive number but down modestly from earlier estimates of 9.5% EPS growth back on 12/31/19.

Historically, stocks tend to follow the direction of corporate profits. Therefore, we are encouraged to see that EPS may have returned to positive growth this past quarter. However, we do recognize that profit numbers for 2020 may continue to come down somewhat during the first half of the year as the world struggles to deal with the coronavirus and global economic growth trends remain weak. In terms of sectors, energy, consumer discretionary and technology are currently forecast to generate the strongest EPS growth in 2020 while utilities, financials and consumer staples are currently forecast to generate the weakest (but still positive) EPS growth in 2020. Looking further ahead, the outlook for 2021 is currently for 10.8% full year EPS growth which is a slight improvement from estimates of 10.4% EPS growth back on 12/31/19. We recognize that the further out we look, our crystal ball for corporate profits gets a little more fuzzy.

In summary, while the coronavirus remains front-page news, we still believe that a U.S. soft-landing and not a recession remains our base case in 2020. News reports from China regarding the coronavirus remain very serious and economic data may get worse for a period of time before things stabilize and start to improve. Most of the impact from the coronavirus appears to be contained within China but that could change. Until the world turns the corner on the coronavirus, we could have periods of market volatility from time to time. As a reminder, according to research from American Funds, U.S. equity markets have on average experienced three 5-10% pullbacks per year and one 10-20% correction every four years. This is something investors have to learn to live with in order to achieve the kind of returns that equities have historically produced over the long-term.

Even if first quarter U.S. and global GDP growth comes in below trend due to the impact of the coronavirus, as long as the virus is contained within a reasonable period of time, we are likely to experience a snap-back in business activity and global growth as we head through the year. We recognize that valuation levels are no longer cheap. Therefore, additional market gains will likely have to be driven by an increase in EPS. On that front, recent EPS data has been somewhat encouraging. The improvement in EPS growth forecast for 2020 could provide a positive tailwind for equity markets as we head through 2020. Low interest rates and accommodative monetary policy should also provide a positive backdrop for economic growth and financial markets in the quarters ahead.

Among the things we worry about, debt levels in the U.S. continue to grow with politicians unlikely to deal with this important issue any time soon, election year politics may start to have a bigger impact on financial markets as we head through the year and geopolitics are an unpredictable factor that may flare up at any time. Lastly, if corporate profits fail to live up to expectations or the coronavirus is not contained within a reasonable period of time, that could add to market volatility and uncertainty in the months ahead.

As always, we welcome any comments you may have.

Respectfully,

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