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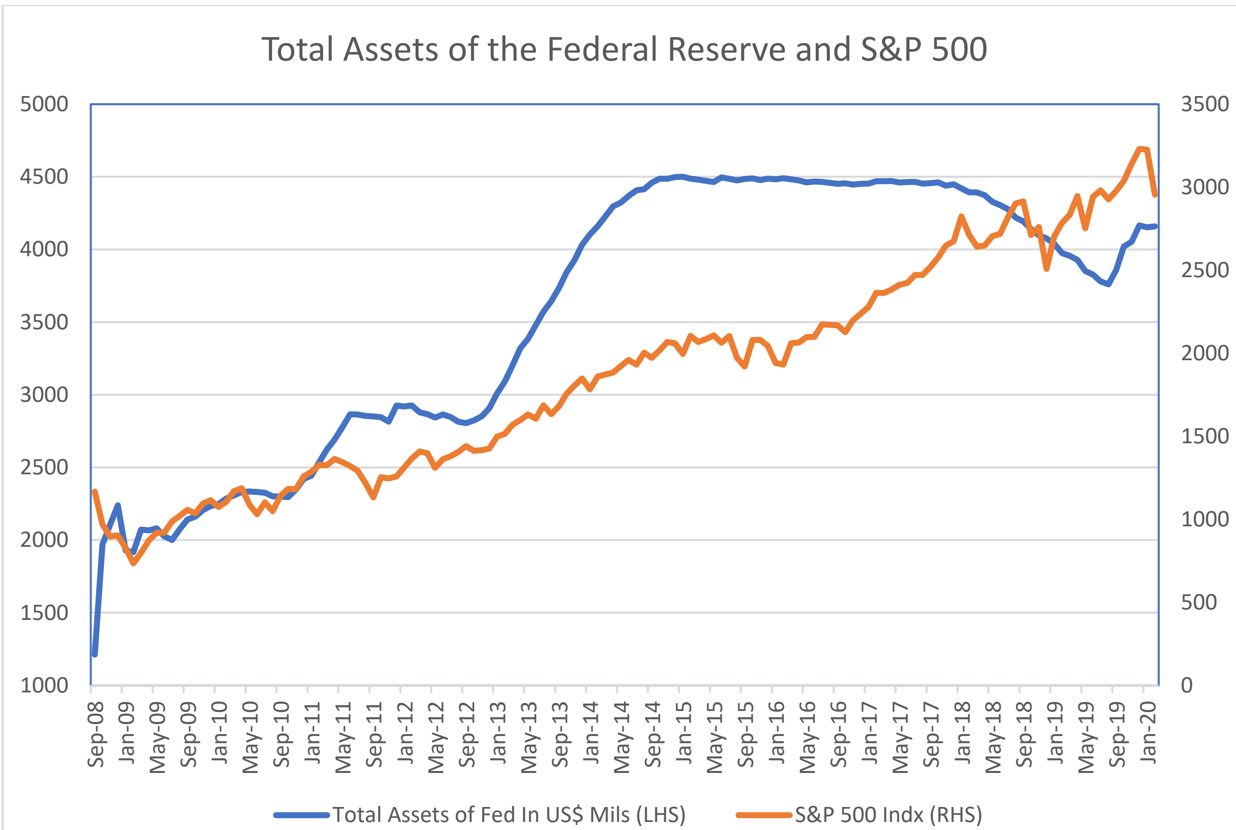
The coronavirus outbreak continues to be a source of volatility in financial markets as investors attempt to assess how deeply the spread of the virus will affect the global economy. As you may have seen, panic selling occurred again yesterday as the S&P 500® Index finished the day down 7.6%. Contributing to Monday's selloff was Saudi Arabia's decision to start an oil price war over the weekend. At last week's OPEC meeting in Vienna, crude oil production cuts of an additional 1.5 million barrel per day were discussed (this would be on top of the 2.1 million barrel per day quota already in place). However, Russia, which had previously been acting in concert with OPEC (but is not an OPEC member), chose not to support the proposed cut. Therefore, Saudi Arabia escalated the situation further over the weekend by committing to ramp up production and cut its official selling prices by $6 - $8 per barrel, in an attempt to take market share and put pressure on Russia. As a result, oil prices fell 26.7% yesterday, the worst daily decline since the start of the Gulf War in 1991. Lower oil prices have potential impact on the U.S. shale industry (the revenue hit could threaten jobs and hinder shale companies' ability to service the high levels of debt that many companies carry). The combination of oil industry threats with the anxiety over the continued spread of the coronavirus outside of China drove yesterday's sell off.

The rollercoaster volatility we have experienced over the last few weeks suggests a market confused by divergent economic outlooks as nobody knows with any real certainty how much, or for how long, the coronavirus will impact the U.S. economy. However, in looking at the economic data that was released in the last few weeks, it appears that the U.S. economy was improving before the virus began to spread. Nonfarm payrolls grew by a very strong 273,000 in January and another 273,000 in February, while the unemployment rate hovered near its multi-decade low of 3.5% in February. Retail sales in January were up 4.4% versus a year ago. In February, sales of cars and light trucks were up 1.9% from a year ago and were above the fourth-quarter average. This suggests that total retail sales for February (which has yet to be released) likely increased as well. The ISM Manufacturing index slipped to 50.1 in February from 50.9 the month before, but a level above 50 still suggests growth in factory activity nationwide. Meanwhile, the ISM Non-Manufacturing Index, which measures a much larger share of the economy, rose to 57.3 in February, signaling strength. Housing starts have been particularly strong lately, coming in at an average annual pace of 1.597 million in December and January, the fastest pace for any two-month period since 2006. In addition, low interest rates (due to the recent drop in U.S. treasury yields) have driven 30-year mortgage rates to their lowest levels in history. Housing and construction tend to have great multiplier effects on the economy, supporting sustained employment in the building trades and follow through spending on durable goods. Should the coronavirus subside by the end of the spring, it is plausible that we could see a V-shaped recovery here in the second half of 2020.

After six weeks of severe disruption in China, new infections appear to be declining. Global policy organizations and health officials appear to be accelerating coordination efforts. More widespread availability of testing kits should help better calibrate mortality risks, calming nerves and supporting a resumption of normal business activities. However, we would expect the spread of the virus to get worse here in the U.S. before it gets better. That is why we should brace ourselves for heightened volatility over the near-term until it is clear that coronavirus cases outside of China have peaked.

But, what if it takes longer to contain the impact of the coronavirus? What if the supply disruptions, combined with demand destruction, ultimately lead to a recession? There are concerns that the Federal Reserve (Fed) has very little room to cut interest rates in order to stimulate the economy, with expectations that they are going to cut the Fed Funds rate by 0.75% at their next meeting on March 18th. However, if the rate cuts do not work and it looks like we are headed for a recession, we would expect the Fed to initialize another round of large-scale asset purchases (quantitative easing or "QE") in an effort to support the economy. When the Fed buys assets, its balance sheet expands, which in turn, has a positive correlation with equity market returns (the chart below shows the growth in the Fed's balance sheet relative to the S&P 500 back to 2008, when QE was first utilized).



Source: Bloomberg

In addition to monetary stimulus, we would expect President Trump attempt to initiate fiscal stimulus programs as well (i.e. tax cuts for individuals and small businesses, infrastructure spending, etc.) to help re-invigorate the economy. We would expect these programs to be beneficial for equities.

As a result, we are not recommending material changes to current asset allocations at this point in time. It is far too early, and too unpredictable in its nature, to assess the ultimate impact of the coronavirus on economic activity and corporate earnings. As we have highlighted before, pandemics like this are not a normal part of the business cycle and are therefore impossible to plan for. The coronavirus is a stark reminder that an unexpected event can occur at any time, and that having an appropriate asset allocation based on your financial situation is critical so that you can withstand the short-term volatility caused by such unforeseen events. We thank you for your ongoing confidence and trust. Please do not hesitate to contact your Relationship Manager with any questions, comments or to schedule a portfolio review.