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As the Coronavirus Goes Global, it's Not Time for a Panic

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Call it a "black swan[1]" event if you would like, but the world is in the midst of another modern-era global health scare that few saw coming and few imagined the repercussions. In just two months' time, a new virus strain has emerged from an old virus. The reaction has certainly been a "grey swan[2]" event with panic and herd-like behavior that has significantly impacted global commerce and human interactions.

Coronaviruses are a large family of viruses that cause illness ranging from the common cold to more severe diseases such as Middle East Respiratory Syndrome and Severe Acute Respiratory Syndrome. A novel coronavirus (nCoV) is a new strain that has not been previously identified in humans. The current novel corona virus is labeled COVID-19.[3] Coronaviruses are zoonotic, meaning they are transmitted between animals and people. Common signs of infection include respiratory symptoms, fever, cough, shortness of breath and breathing difficulties. In more severe cases, infection can cause pneumonia, severe acute respiratory syndrome, kidney failure and even death.[4]

The outbreak of COVID-19 came at a particularly vulnerable point in the global business cycle. World output expanded by just 2.9 percent in 2019 – the slowest pace since the 2008-09 global financial crisis – and just 0.4 percentage points above the 2.5 percent threshold typically associated with global recession.[5] During the past month, the combination of an unprecedented quarantine on Hubei province (population 58.5 million) and draconian restrictions on inter-city (and international) travel has brought the Chinese economy to a virtual standstill. Even as the pace of new cases slows in China, the number of COVID-19 cases outside China has risen, including in South Korea, Italy, Iran, Austria, Croatia and Spain.

While there have been just 53 cases in the United States, and no fatalities as of Feb. 25[6], the Centers for Disease Control and Prevention nonetheless said Americans should prepare for school closings, cancellations of sporting events, concerts and business meetings *if* the coronavirus spreads in the U.S. "We expect we will see community spread in this country," said Nancy Messonnier, director of the CDC's National Center for Immunization and Respiratory Diseases. "It is not a matter of if, but a question of

[1] Black swan: an unpredictable or unforeseen event, typically one with extreme consequences.
[2] A grey swan is a highly probable event with three principal characteristics: it is predictable; it carries an impact that can easily cascade; and, after the fact, we concoct an explanation that recognizes the probability of occurrence, but shifts the focus to errors in judgment or some other human form of causation.
[3] https://www.who.int/health-topics/coronavirus
[4] Ibid.
[5] When China Sneezes, Stephen S. Roach, Fa-mag.com, 2/24/2020
[6] Source: https://systems.jhu.edu/research/public-health/ncov/

when, this will exactly happen." She added that the outbreak is "rapidly evolving and expanding." and that Americans should prepare for the coronavirus epidemic on our shores and to assume it will be bad.[7]

Global stock markets first sold off in late January over the first coronavirus news, but later rallied into early to mid-February as it appeared that the Chinese government had contained the spread of COVID-19. As new cases began to appear in countries far from China, risky assets began to falter once again.

The S&P 500 index hit a new all-time high on Feb. 19, 2020. Since then, the coronavirus has spread, government bond yields have dropped significantly, risk assets have corrected, and equity volatility has spiked. The S&P 500 is now about 7 percent off its recent high (as of Feb. 25th). Companies that source inputs from China are being impacted from shutdowns. This is impacting the supply of critical components. Companies that sell into China are losing revenue as a result of consumers and businesses being shut down, so final demand is also being impacted. That is why major companies such as Apple, Coca-Cola, United Airlines and MasterCard have issued warnings. Visibility is limited and the situation is fluid.

Businesses are naturally on edge. Quarantines are creating transportation bottlenecks across the globe. In parts of China, port terminals have been jammed because of a shortage of workers and truck drivers. A decline in container traffic is exacerbating a slowdown in Chinese manufacturing and trade that is rippling to the rest of the world.

China now accounts for one-third of global trade – about 10 times more than during the SARS epidemic – and about 20 percent of exports from South Korea, Vietnam and Japan. Many manufacturers have shifted production out of China in recent years amid trade uncertainty and rising labor costs, but it remains a linchpin in business supply chains.

According to DWS Asset Management, for the global economy to stabilize and then perhaps cause stock markets to rally, three conditions must be met in their view:

- First, the spread of coronavirus must be contained rapidly.
- Second, production must be brought back to pre-crisis levels as quickly as possible.
- And third, central banks and finance ministers must also deliver the additional stimulus that markets are seeking.[8]

"On the last of these three conditions, there is good reason for optimism. The first liquidity injections and interest-rate cuts have been delivered, especially by China. Tax cuts, government aid and other fiscal as well as regulatory measures complete the picture. Other countries, mainly in Asia, are joining in. Thailand, the Philippines and Indonesia have already cut interest rates, as have Brazil and Mexico. The list is likely to get longer in the days to come.[9]"

Assessing to what extent China is back in business is trickier. Meanwhile, analysts have to rely on traffic-congestion data, air-pollution levels or similar indicators to provide an accurate picture of economic activity. These indicators currently point to a slow increase in output from low levels.

According to The Wall Street Journal, "Panic is prompting more government travel restrictions. Israel is banning foreign visitors from Japan and South Korea. Afghanistan has closed its border with Iran. More countries may follow."[10] The World Health Organization seems to be trying to ease anxiety. "For the moment we are not witnessing the uncontained global spread of this virus," WHO Director-General Dr. Tedros Ghebreyesus said recently.

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[7] Source: Bloomberg, 2/25/2020
[8] As the Coronavirus goes global, risks have risen, CIO View, DWS Asset Management, 02/24/2020
[9] Ibid.
[10] A Market Pandemic, Editorial Board, The Wall Street Journal, 2/24/2020

The reduction in global output from the coronavirus will affect the U.S. economy, and all of this will inevitably knock something off American GDP. Investors signaled as much with Monday's and Tuesday's rush out of equities and into U.S. Treasuries, with the yield on the 10-year note falling to a near-record low of 1.32 percent.

So, what are the positives? The U.S. economy has a sturdy foundation in low unemployment, strong wage growth and robust consumer spending. Stocks were on the expensive side given some weaker corporate earnings, so a modest market correction doesn't portend an economic recession. This selloff could be the catalyst for the Federal Reserve to cut short-term interest rates, which would benefit scores of borrowers. The market is pricing in a 90 percent probability of a rate cut within the next two Fed meetings.

They Must Know Something I Don't

Another factor at work in this market pullback is human emotions – which often are divorced from facts. A race to protect one's personal health (avoiding the coronavirus) is now entangled with the fear of large losses in one's monetary assets (your 401k account, for example). This fear is so ingrained in human behavior that it often leads to "the herd effect" — a phenomenon in which individuals base their actions on the actions of others, most often in the absence of evidence and in contravention of their own beliefs and knowledge.

When applied to behavioral finance and market dynamics, this effect often causes either large unsubstantiated rallies or sudden selloffs based on seemingly little justification. In a correction, sellers will often pile on, believing those other sellers *know something they don't*. As the number of sellers increases, so does the correction, creating what renowned sociologist Robert Merton called a "self-fulfilling prophecy." Merton observed that when a person is gripped by a belief or fear, often unjustified, he or she will behave in a way that conjures that very outcome leading to a "reign of error."

However unnerving self-fulfilling prophecies might be for investors, they should be expected. In any swiftly occurring capital market selloff, investor fears are a common and very human response. These fears are derived from a belief that perhaps an economic contraction is imminent. They fear that some serious, irreversible, world-shattering unknown consequence will result if the selling continues. Like any wise sage, we always remind investors to remember their history as a guide when drifting into uncertain periods. Eventually, the selling stops and buying resumes.

In *More Than You Know*, behavioral finance pundit and prolific author Michael J. Mauboussin points out that the stock market has no defined outcome and no defined time horizon. This means that it's actually the prices in the financial market that both inform its participants about the future and influence decisions.

When investors imitate one another, or rely on the same information cascades, market efficiency is lost. The actions of some market players induce others to take the same course of action (buy or sell) based on the same signals from the environment without consideration that others are doing the same. Most important, they might be ignoring clear signals that it's in their best interests to refrain from taking the same action as a large group of others.

In some sense, information cascades are related to herd behavior, exacerbated during periods of extreme sentiment. "That unintended system-level consequences arise from even the best-intentioned individual-level actions has long been recognized," Mauboussin wrote in his second book, *Think Twice*. "But the decision-making challenge remains for a couple of reasons. First, our modern world has more interconnected systems than before. So we encounter these systems with greater frequency and, most likely, with greater consequence. Second, we still attempt to cure problems in complex systems with a naïve understanding of cause and effect."

Feedback loops involving investor confidence occur in the context of a complex social and psychological environment. Noted economist Robert Shiller stated in his famous book *Irrational Exuberance* that feedback loops are a vicious circle. "Underlying this feedback is a widespread public misperception about the importance of speculative thinking in our economy. People are accustomed to thinking that there is a basic state of health of the economy, and that when the stock market goes up, or when GDP goes up, or when corporate profits go up, it means that the economy is healthier," Shiller wrote. "It seems as if people often think that the economy is struck by some exogenous maladies, and that the stock market is just a reflection of those shocks. But people do not seem to perceive how often it is their own psychology, as part of a complex pattern of feedback, that is driving the economy."

While asset price bubbles represent one set of challenges, it’s during negative feedback cycles that restraint and thoughtfulness must prevail. Merton concluded that the only way to break the cycle is to redefine the propositions on which the false assumptions were originally based.

Six Things Investors Should Remember

It appears that a meaningful amount of both panic and hysteria in the last few days reflects a rapid rise in investor uncertainty. Uncertainty means that investors will demand a higher risk premium — and, thus, lower asset prices — even in a world where a recovery is inevitable when the COVID-19 virus threat is diminished and the virus is relegated to perhaps a run-of-the mill endemic strain. Even with this “novel” threat facing human behavior, hundreds of years of market history tell us that the current spate of volatility and uncertainty will be dispelled.

However, the time it will take to do so is unknown. In the meantime, investors should expect that markets will potentially experience bouts of volatility over the next few months, and the ultimate timeframe for markets to find new levels to attract buyers cannot be foretold.

When fear and uncertainty find their way into headlines, investors should remember these six things:

1) **Breathe, Don’t Panic** — making rash decisions during times of emotional stress often have negative consequences in the future and can potentially threaten long-term financial goals.
2) **Separate Fact from Opinion** — with thousands of “expert” voices in earshot, it’s important to focus on the facts when reviewing stories on the market and the economy in the press.
3) **Remember Your Long-term “Why”** — why are you investing for the long-term? Commonly, the reason is to set aside some current assets and income for future needs. Has that changed?
4) **Discuss Your Fears and Concerns** — your financial advisor will help you navigate the short-term emotional swings of personal finance. The more you discuss your angst, fears and concerns with your advisor, the more they can tailor their professional guidance to your specific situation.
5) **Know Your Needs** — investors should always know their needs for money. If you need to use some of your investment assets in the short term for a major purchase or living expenses, it’s wise to reassess where those monies are located and in what they are invested.
6) **Stay Diversified*** — when appropriate, a well-diversified portfolio can alleviate concerns about being invested in the right place at the right time. Properly allocating your assets among various asset classes and diversifying your portfolio among several investment vehicles is meant to provide you with an efficiently diversified portfolio strategy that reduces volatility.

During this cycle of uncertainty, investors should actively engage their financial advisors to gather their valued perspectives and re-examine or review their long-term financial goals and plan to reach them. Unless life circumstances have changed, it’s important to ignore the herd and “stay the course.”

**Asset allocation/diversification of your overall investment portfolio does not assure a profit or protect against a loss in declining markets*

About the author

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Martin Landry is the manager of the PMG and a senior portfolio manager at Avantax, where he oversees the planning, execution and success of the PMG, a role that includes implementing the IMS Select and RMS Select Portfolios discretionary model portfolios. Martin has over 20 years of investment experience. He began his career at Avantax in 2010 and previously served as an investment due diligence analyst and a portfolio manager prior to stepping into his current position in 2016.

Martin received his Bachelor of Science degree in communications from Texas A&M University — Commerce and his Master of Business Administration degree in management from the University of Texas at Tyler. After a 14-year career in broadcast television news as a video photojournalist, reporter, editor and producer, Martin was drawn to the financial services industry because of his interest in how the capital markets work and his desire to help others make sensible decisions regarding their savings and investments. He sees the responsibility of his current role as an important and humbling endeavor and appreciates the trust and care it entails. Before joining Avantax Wealth Management, Martin gained experience in the industry as a financial consultant at Merrill Lynch, a portfolio manager at Bank of America and as a senior investment analyst at GuideStone Capital Management. He is a member of the CFA Society of Dallas-Fort Worth, the CFA Institute, the CIPM Association, the Investments & Wealth Institute, the Texas Chapter of the CAIA Association and the Dallas chapter of the Financial Planning Association. He holds the Chartered Financial Analyst® designation and has passed the FINRA Series 7 and 66 exams.

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