Avantax
Wealth Management™

CORONAVIRUS UPDATE: STOCK SELLOFF MIGHT BE EXAGGERATED; ECONOMIC IMPACT STILL UNCLEAR, FEAR REMAINS

Martin E. Landry, CFA, CFP®, CAIA, CIMA, CTFA, CIPM, AIF
Director, Portfolio Management Group
Avantax Wealth Management℠

Tuesday, March 3, 2020

Update

Concern remains elevated about the coronavirus behind an epidemic in China and dozens of other countries. The number of people newly diagnosed with the illness caused by the virus appears to be on the decline in the epicenter of Hubei Province, China, though it is still high. International health officials are still worried about growing outbreaks of the virus in countries such as South Korea, Italy, Iran and Japan. It appears that some of the cases outside of China include people who neither have been to China nor in contact with anyone who has. On Friday, Feb. 28, the World Health Organization raised the global risk for the new virus from “high” to “very high.”

U.S. health officials have warned that they expect more transmission of the virus in the country. Scientists and public-health officials keep learning more about the virus, called Severe Acute Respiratory Syndrome Coronavirus 2, or SARS-CoV-2. The disease it causes is called COVID-19. This new virus belongs to a family of viruses known as coronaviruses. Seven strains are known to infect humans, including this new virus, causing illnesses in the respiratory tract. Four of those strains cause common colds. Two others, however, are significantly more serious infections: SARS, and Middle East respiratory syndrome, or MERS.[1]

SARS-CoV-2 appears to be less deadly than a related pathogen—SARS, which erupted in China in 2002 and spread globally in 2003. SARS killed about 10 percent of people it infected, while less than 3 percent of people confirmed to have COViD-19 have died, according to publicly released data.

The current risk to the U.S. public is low, says the U.S. Centers for Disease Control and Prevention, although, of the date of this commentary, 6 deaths related to the virus have been announced in the U.S. Even so, the virus isn’t spreading widely. The majority of confirmed infections are in people who were infected while abroad and were quarantined upon their return to the U.S., although some “community spread” has occurred.

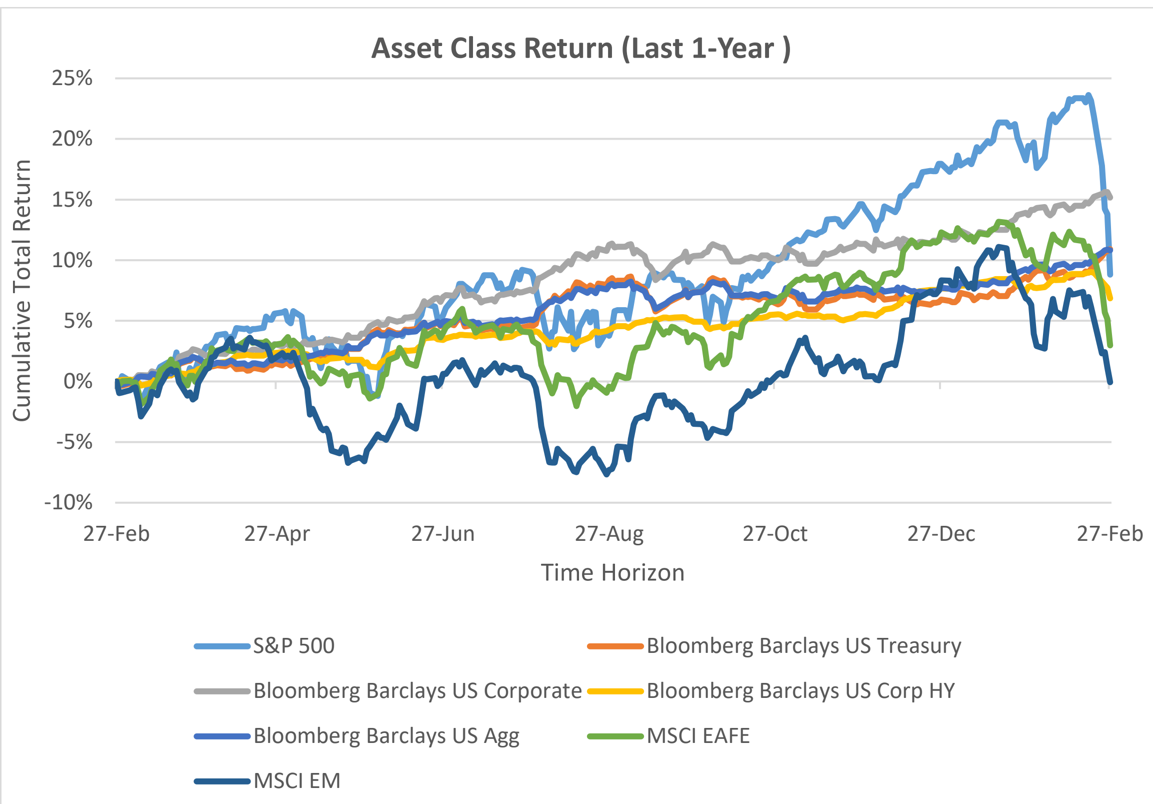
[1] What We Know About the Coronavirus, From Symptoms to Who Is at Risk, Betsy McKay, Wall Street Journal 2/27/20

Market Impact

Markets sent a clear message in recent days: investors are afraid of the spillover effects of the coronavirus. The disease's global progression and containment challenges are seen as impediments to global economic recovery. Continued fear over the economic fallout from this health scare has taken over global financial markets, sending equity indexes to a seven-day losing streak last week and sparking intense demand for government bonds (Treasurys) and high-quality corporate debt. In the U.S., all equity sectors are now in a "correction." [2] According to Bloomberg[3], the current correction in U.S. stocks, as measured by the S&P 500 Index, is the fastest ever – it took only six days.

From Feb. 19 through Feb. 28, the S&P 500 Index fell nearly 13 percent, while foreign stocks as measured by the MSCI EAFE and MSCI EM (Emerging Market) Indexes were down around 10 percent. Meanwhile, over the past week, high-quality corporate bonds and U.S. Treasurys are up about 2 percent, U.S. This is normal to see a "flight to quality" during times on market stress and uncertainty.

In reviewing the chart below, you will see that this selloff has retraced the S&P 500 Index back to levels last seen in October 2019. A similar retracement is evident for the MSCI EAFE and MSCI EM Indexes. Meanwhile, you will notice that there has been no retracement for Treasurys or high-quality corporate bonds.



Source: Bloomberg (Period 2/27/2019 - 2/27/2020)

---

[2] A correction is defined as a decline of 10 percent or more in an index from its most recent high.

[3] We Just Witnessed The Fastest Stock Market Correction on Record, Sarah Ponczek, Bloomberg 2/27/2020

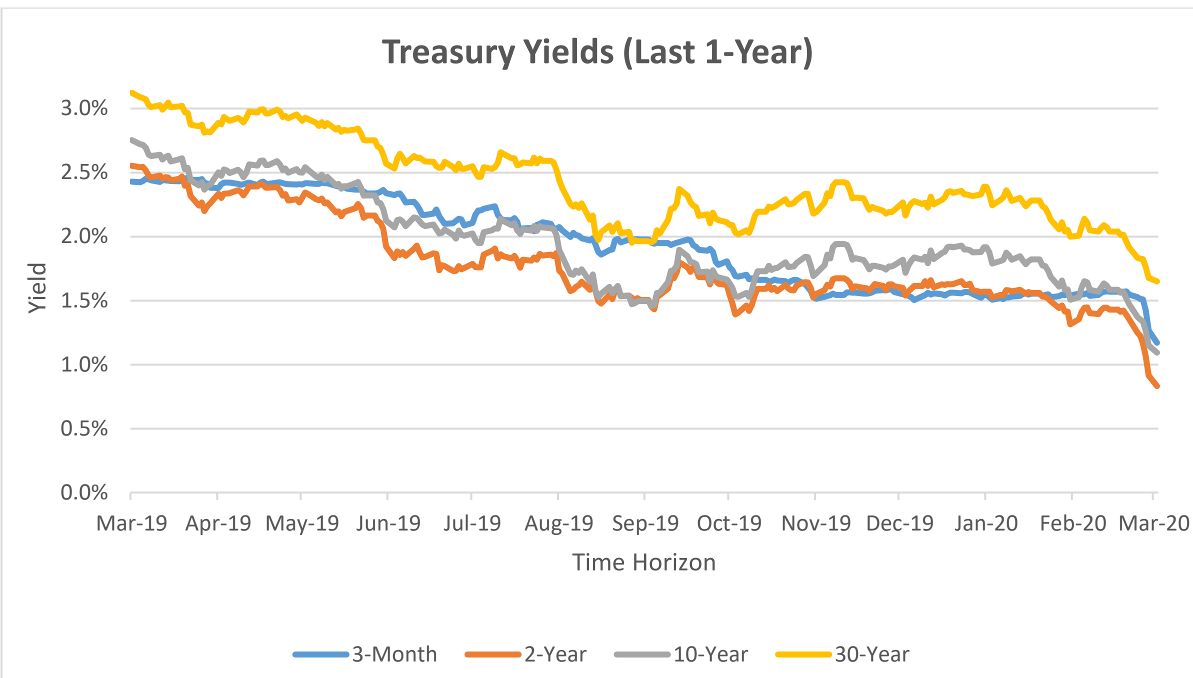
For the bull market to end (a decline of 20 pecent or more from its highs), the S&P 500 Index would have to fall to around 2709, a level it last touched in February 2019.[4] The strong performance of domestic large-cap stocks since late December 2018 has attracted billions of dollars from investors in early 2020. The use of margin (leverage) to buy stocks has increased as has bullish derivative bets on the rise of U.S. stocks. “So while the coronavirus is clearly the selloff’s proximate cause, surging enthusiasm in the weeks and months before is accelerating it.

From early October to last week’s peak, the S&P 500 jumped 17 percent, an expansion that, should the bull market end now, would qualify for the second-fastest – at this late stage – ever recorded” notes Bloomberg reporter Lu Wang.[5]

On Monday, March 2, the yield on the 10-year U.S. Treasury note hit a record low of 1.08 percent. The 30-year U.S. Treasury bond’s yield fell to 1.65 percent. The two-year Treasury fell to 0.81 percent. The 2-year and the 10-year yields are now below the 3-month Treasury Bill, suggesting that the Federal Reserve will soon act to lower the Federal Funds rate at least once or twice in coming months to get aligned with market expectations.

Not surprisingly, below-investment grade bonds (i.e. high-yield bonds) have been under immense pressure as investors continued to dump the riskiest corporate debt as the coronavirus scare worsens, pushing up the risk of companies defaulting. High yield spreads, the difference between yields on high-yield bonds and yields on Treasuries, as represented by the ICE BofAML US High Yield spread has widened 138 bps over the past week and 44 bps this year.

The spread measures the amount of extra interest that investors demand to lend to corporate borrowers with a greater risk of defaulting – in other words, it’s a way to gauge the perceived risk that investors won’t get their money back.



Source: Bloomberg (Period 03/02/2019 - 03/02/2020)

---

[4] History’s Fastest Crash Is the High Price for Unbridled Optimism, Lu Wang, Bloomberg 2/28/2020

[5] Ibid.

Economic Impact

As the equity markets selloff has continued, focus is turning to a significant change in sentiment that this public health scare is derailing real commerce and economic activity in multiple countries and industries. The realization that companies and individuals are unable or unwilling to produce or purchases goods and services and are postponing decision-making is being reflected in asset prices. The Economic Research team at Northern Trust notes that “controlling the outbreak is both a medical and a psychological exercise. Unless and until there is a broad sense that the crisis has passed, consumer and business behavior will remain subdued.”[6]

The Economics Research team at Northern Trust states that “the direct channel of contagion to the U.S. economy is the financial markets, which are faltering. To be fair, equities have proven impressively resilient in the face of various challenges during the past 11 years. But global prospects are being downgraded, and risks remain on the downside. That combination may prompt a more sustained ‘risk-off’ posture from investors. And if the correction is sustained, cost containment could follow.”[7]

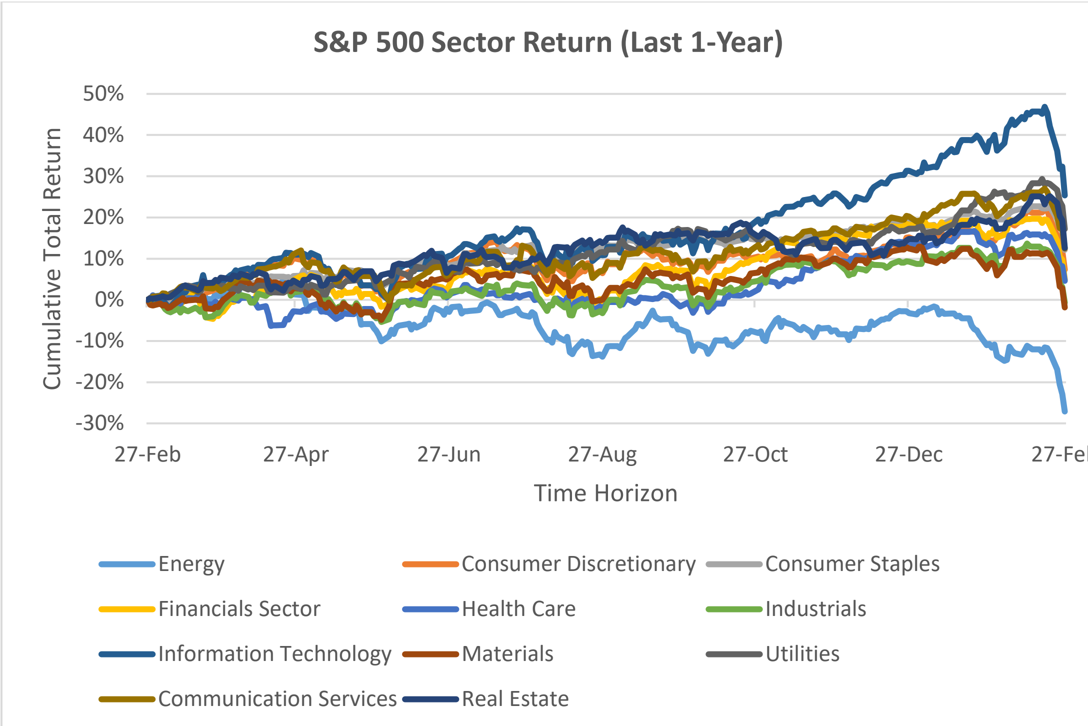
Northern Trust continues that “every country and company with exposure to China, whether on the supply or demand side, is feeling the slowdown. Countries in closer proximity and with tighter production links to China are feeling the worst effects of the slowdown, but no country is immune.”[8]

Impact on Stock Sectors and Industry

Sector-wise, the Information Technology sector, which has had a phenomenal run in the past one year with a cumulative total return of close to 47 percent, has pulled back the most amid the coronavirus upheaval, down 21.5 percent from the record close reached on Feb. 19, 2020.

The energy sector, which has been underperforming for nearly a year because of worries of an oversupply, now faces fears of lack of demand from China, the world’s biggest importer of crude oil; subsequently, the sector is down about 27 percent in the last one year and about 16 percent from Feb. 19. The selloff has been widespread across all 11 sectors with even non-cyclicals like Consumer Staples and Utilities not being spared, down about 10 percent from Feb 19. That being said, Utilities, which is overwhelmingly domestic and not very likely to be affected too much whether people are commuting or staying home, has been the best performing sector so far this year.

[6] Weekly Economic Commentary, Northern Trust Global Economic Research, 2/28/2020
[7] Weekly Economic Commentary, Northern Trust Global Economic Research, 2/28/2020
[8] Ibid.



Source: Bloomberg (Period 2/27/2019 - 2/27/2020)

With similarities to the 2003 outbreak of SARS, certain industries may stand out as potentially leading the freefall in the market. Travel, transportation, insurance, commodities and technology will likely continue to decline if the virus panic persists. We could also see a temporary disruption in retail, particularly for retailers who outsource a significant portion to Chinese manufacturers.

Sector/Industry Impact of SARS (2003) and Coronavirus (2020) Pandemics

	MSCI WORLD				MSCI EM				S&P 500				Solactive Global Luxury
	Transportation	Retail	Hotels	Textile & Luxury	Transportation	Retail	Hotels	Textile & Luxury	Transportation	Retail	Hotels	Textile & Luxury	
SARS Pandemic: 01/15 to 04/24/2003	-0.2%	8.2%	0.0%	-0.6%	-7.5%	2.9%	-18.9%	-12.9%	-0.8%	9.8%	3.4%	5.7%	-4.0%
"SARS Peak to Trough Percent Decline"	-10.8%	-16.2%	-19.0%	-13.1%	-2.1%	-13.9%	-19.1%	-17.8%	-16.6%	-16.2%	-20.0%	-12.4%	-28.5%
"SARS Peak to Trough Days to Recover"	49	49	55	78	5	49	55	94	52	35	51	41	141
Coronavirus: 01/17/2020 to 01/31/2020	-2.8%	-1.5%	-5.0%	-7.5%	-6.3%	-7.6%	-10.1%	-9.9%	-5.7%	1.1%	-5.5%	-8.8%	-9.2%

Source: QMx (Prudential), *"The Coronavirus Pandemic—the End of the Rally or a Buying Opportunity?" Market Pulse, February 2020, Bloomberg 1/31/2020*

It is anticipated that online travel booking sites will see about a 1 percent decrease in growth as people limit travel, with China accounting for about 15 percent of the overall $700 billion online travel market. While hotel revenue will be affected as well, giants such as Marriott and Hilton have approximately minimal exposure in the region with 16 percent and 9 percent of their rooms, respectively, located in the

Pacific. Whereas the Hyatt and Wyndham hotel lines may be impacted more substantially with about 20 percent of their rooms in that region.[9]

While airlines and cruise ships might see a decrease in future earnings, many operators have minimal exposure to Asia, with large cruise liners have 5 percent or less of their fleets in Asia. American-based airlines, such as Delta, United and American, might be more insulated than others airlines, having only about 3 percent to 10 percent of earnings before interest and taxes coming from Pacific routes. Additionally, these companies could reroute some of these lost flights to other areas. It is interesting to note that China accounts for only 25 percent of all Pacific travel.[10]

Auto sales will likely be impacted globally; however, German manufacturers stand to be impacted the most. About 30 percent to 35 percent of pretax profit for several major Germany automakers comes from China. As much as 50 percent of BMW, Daimler and Volkswagen free cash flow comes from the Chinese consumer, and China is the single largest market for BMW, Volkswagen and Mercedes.[11] While these major auto companies have plans to continue expanding in China, it remains to be seen if some of these plans will be delayed or postponed.

Looking at commodities, wholesale gas and diesel prices have declined by 10 percent since the outbreak, and it is likely the virus will continue to weigh heavily upon this commodity as consumers attempt to quarantine themselves at home.[12] While copper futures have gradually declined since June 2018, the coronavirus outbreak will likely spur further decline for copper this year. China imported 3.2 million tons last year[13] and this outbreak could further decrease its already declining imports.

The effect on insurance companies could be a mixed basket. U.S. insurers might see minimal impact to their bottom lines with few to no claims; however, some large companies such as Sun Life, Manulife, MetLife and Prudential might see some revenue decline from joint ventures in the Pacific region. In contrast, Reinsurance Group of America generates about 24 percent of premiums from Asia and such carriers could see significant impact to their bottom line depending on the duration of the virus.[14]

While most likely temporary, disruption to the technology sector is expected. The manufacturing and shipping of components such as LEDs and memory chips will likely be delayed. A decrease in their supply could increase component costs while also delaying or even halting global production of products using these components. If the China/U.S. trade challenges didn't convince companies to move at least part of their key component manufacturing away from China, this event could be the catalyst needed for some companies to make the shift.

Besides most LEDs being produced in China, some 3-D NAND and DRAM supply (made in China) will be stalled with few to no options for substitutes in the interim. Prominent companies that could be severely affected by these delays are Samsung, SK Hynix, Intel, Taiwan Semiconductor, SMIC, and Diodes. Furthermore, companies such as Apple, Qualcomm, and Hon Hai could also be impacted as final-product

---

[9] Brian Egger Team: Gaming & Lodging, "US Coronavirus Impact Goes Beyond Travel, Tech," Bloomberg Intelligence, February 27, 2020

[10] Ibid.

[11] Michael Dean Team: Autos and Gillian David Team: Autos, "German Autos Most Exposed to China Threat," Bloomberg Intelligence, February 27, 2020

[12] Richard Chatterton, Sisi Tang and Luxi Hong, "COVID-19 Oil Demand Impact Update," Bloomberg NEF, February 24, 2020

[13] "China's refined copper imports to fall almost 15 pct. in 2019 – Antaike" https://www.reuters.com/article/china-metals-copper/chinas-refined-copper-imports-to-fall-almost-15-pct-in-2019-antaike-idUSL3N21G1YX (accessed February 28, 2020)

[14] Brian Egger Team: Gaming & Lodging, "US Coronavirus Impact Goes Beyond Travel, Tech," Bloomberg Intelligence, February 27, 2020

manufacturing and sales decrease. For example, Apple has a notable presence in China among consumers with approximately 16.8 percent of sales of fiscal 2019 sales coming out of China.[15]

Finally, it is expected that both retail sales and retail supply chains will be impacted, yet the breadth of this impact is still forthcoming. Substantial dependence globally upon Chinese factories for apparel production could temporarily disrupt retailers. China is the leading exporter of clothing and footwear to the U.S. For example, all of Nike's 110 factories are in the affected provinces; 120 (out of 122) of Adidas' production facilities are located in these same provinces.[16] These are just two examples of retail firms whose supply chains could be curbed if this virus continues to wreak havoc on the province.

In addition to concerns of reduced output by retailers due to delayed supply chain production, a reduction in retail sales within China could impact revenue for some of these major firm even into the second and third quarters of 2020. Nike, Adidas and VF Corp (including brands such as The North Face, Timberland, and Dickies) have 16 percent, 18 percent, and 8 percent, respectively, of their sales coming for China.[17]

Outside China, Japan and South Korea are two countries whose local economies are expected to be jolted as the virus ripples through these countries. While we wait to see how fast the virus spreads and the impact of potential business and commerce closures in these nations, supply chain disruptions have already begun to affect these economies. Certain automobile companies in these regions have halted manufacturing due to lack of critical components from China. It is expected that Chinese tech supply chain disruption could affect large firms such as Nintendo, Panasonic, LG Electronics and Samsung, who each derive 30 percent or less of their components from China.[18] This problem could be exacerbated over the coming weeks if production in China continues to stall. If the virus continues to spread as it did in China, these two countries are likely to see a decrease in consumer spending, which could significantly impact each country's GDP – in fact, Goldman Sachs is forecasting Japan to fall into recession in 2020.[19]

Fear, Panic and Courage

Globalization is here. Noted "Black Swan" author Nassim Taleb wrote in 2007 that globalization "creates interlocking fragility."[20] He says that globalization does reduce volatility and gives the appearance of stability, however, it sets us up for potentially "devastating" Black Swans. The sudden entry of a new virus onto the world's stage is testing his proposition, but humans likely have more control than they think, at least of their own emotions when it comes to investing.

The Wall Street Journal columnist and best-selling author Jason Zweig writes in his book *Your Money & Your Brain:*

"Dread and knowability come together to twist our perceptions of the world around us: We underestimate the likelihood and severity of common risks, and we overestimate the likelihood and severity or rare risks – especially if we have never experienced them. When we feel we are in charge and we understand the

---

[15] Ibid.

[16] Ibid.

[17] Ibid.

[18] Allison Nathan, Gabriel Lipton Galbraith, Andrew Tilton and Jenny Grimberg, "2020's BlackSwan: Coronavirus," Top of Mind, Issue 86, Goldman Sachs, February 28, 2020

[19] Allison Nathan, Gabriel Lipton Galbraith, Andrew Tilton and Jenny Grimberg, "2020's BlackSwan: Coronavirus," Top of Mind, Issue 86, Goldman Sachs, February 28, 2020

[20] The Black Swan: The Impact of the Highly Improbable, Nassim Nicholas Taleb, Random House, 2007.

consequences, risks will seem lower than they truly are. When a risk feels out of our hands and less comprehensible, it will feel more dangerous than it actually is."[21]

The awareness of the media's coverage of the coronavirus and the stock market selloff causes a "flight or fight" response in your brain. The surge of stress signals generated from the amygdala during fear of loss of health or financial loss can cause a heightened state of anxiety. Zweig states that if the fear turns into "a moment of panic (it) can wreak havoc on your investing strategy." Because the amygdala is so attuned to big changes, a sudden drop in the market tends to be more upsetting than a long, slower decline."[22] Investors are biologically induced into short-term thinking by the stress hormones released during stress episodes of acute fear.

Richard Peterson, author of "*Inside the Investor's Brain: The Power of Mind Over Money*", has several salient points about fear and panic as it relates to investing. He says that "fear is uncomfortable, and it can drive investors to make rash, often poor financial decisions. Fear can be so overwhelming that it overrides reason, patience, and good judgment."[23] He says that fear is different from panic. While fear is anticipatory, panic is reactive. Panic causes humans pressure to act urgently to relieve the underlying anxiety.[24] Studies have shown that when investors sell during sharp drops, they are much more likely to stay uninvested for longer periods of time.

Peterson says that "after a large loss, it is important to stay involved in investing, even in a very small way, to work through one's experiences. The memory of a traumatic event in the markets will linger as long as one stays uninvolved. Studies suggest that if the markets are calm, investors will tend to project the tranquility into the future. During bear markets and periods of extreme volatility, fearful investors often cannot take the pain in part because they project that it will continue indefinitely. They sell in order to escape the pressure of declining positions – pain for which they can see no end.

Our advice for investors struggling with fear and panic during this bout of market volatility:

- Ignore what other people are doing.
- Wait! Resist the temptation to sell! Take the time to logically think though your personal situation.
- Exercising emotional courage during periods of high anxiety leads to better outcomes.
  - The courage required to push back against fear and the panic reflex is honed through experience, practice and mental exercise.
- Calmly go through your plan. Don't have a plan? Get one.
- Talk to your financial advisor!

Jason Zweig notes "the best investors make a habit of putting procedures in place, in advance, that help inhibit the hot reactions of the emotional brain."[25] Fortunately, everyone has the power to change their point of view and maintain an objective perspective by consciously manipulating their thoughts, beliefs and expectations.

---

[21] Your Money & Your Brain, Jason Zweig, Simon & Schuster Paperbacks, 2007.

[22] Ibid.

[23] Inside the Investor's Brain: The Power of Mind Over Money by Richard L. Peterson, Wiley Trading, 2007.

[24] Ibid.

[25] Jason Zweig, Your Money & Your Brain, Simon & Schuster Paperbacks, 2007

About the author

Martin E. Landry, CFA, CFP, CAIA, CIMA, CTFA, CIPM, AIF
Director, Portfolio Management Group, Avantax Wealth Management.

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 VestAdvisor Select, IMS Select and RMS Select Portfolios discretionary model portfolios. Martin has over 21 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, 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.

Additional writing by:

Jennifer Hutchins, CFA
Senior Portfolio Manager, Avantax Wealth Management

Malav Gandhi
Portfolio Analyst, Avantax Wealth Management

Disclosures

All opinions expressed and data provided are subject to change without notice. Some of these opinions may not be appropriate to every investor. This commentary should not be considered a solicitation or offering of any investment product. This commentary is for informational purposes only and should not be construed as investment advice.

Index Definitions

The S&P 500 Index is widely regarded as the best single gauge of large-cap U.S. equities. The index includes 500 leading companies and covers approximately 80 percent of available market capitalization.

The MSCI EAFE Index is recognized as the pre-eminent benchmark in the U.S. to measure international equity performance. It comprises of the MSCI country indices that represent developed markets outside of North America: Europe, Australasia and the Far East.

The MSCI Emerging Markets Index captures large-cap and mid-cap representation across 26 Emerging Markets (EM) countries. With 1,404 constituents, the index covers approximately 85 percent of the free float-adjusted market capitalization in each country.

The Bloomberg Barclays US Corporate Bond TR Index measures the investment grade, fixed-rate, taxable corporate bond market. It includes U.S. dollar-denominated securities publicly issued by U.S. and non-U.S. industrial, utility and financial issuers.

The Bloomberg Barclays US Aggregate Bond TR Index is a broad-based flagship benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate pass-throughs), ABS and CMBS (agency and non-agency).

The Bloomberg Barclays US Corporate High Yield Bond TR Index measures the US dollar-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high-yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below.

The Bloomberg Barclays US Treasury TR Index measures U.S. dollar-denominated, fixed-rate, nominal debt issued by the U.S. Treasury. Treasury bills are excluded by the maturity constraint but are part of a separate Short Treasury Index.

Index performance does not reflect the deduction of any investment-related fees and expenses. It is not possible to invest directly in an index.