Rockefeller Asset Management
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Monthly Market Review

March 3, 2020

Rude Awakening

From infectious optimism to panic selling; COVID-19 on U.S. soil

During the first three weeks of February, there was a disconcerting divergence of opinions between experts in the real world and equity investors in the financial world on the impact of the novel coronavirus disease, now officially named COVID-19. Many real-world experts such as epidemiologists, virologists, current and former public health officials, warned that a pandemic appeared unavoidable. Some business executives compared the outbreak to a black swan event. However, in the rarefied financial world where everything gets simplified into red and green ticker symbols and numbers on monitors, equity investors collectively shrugged off the crisis as a transitory disruption. Some also salivated at the prospect of policymakers coming to the rescue with massive monetary and fiscal stimulus. Their infectious optimism drove up the S&P 500 Index by as much as 5% from the end of January to an all-time high on February 19th.

Just as the speculative fever was getting out of this world – e.g., Virgin Galactic Holdings, a pre-revenue space travel stock that had more than tripled seven weeks into the new year – a sudden surge of new COVID-19 cases in South Korea, Japan, Italy, and Iran shook equity investors out of their complacency and triggered the fastest, waterfall-like U.S. market correction on record and took equity indices back to last October's levels. Unlike equities that were slow to discount potential risks, U.S. Treasury bond yields have been drifting lower since the start of the year, and the 10 and 30-year yields plunged to record lows. As a result, the 3-month/10-year yield curve has once again gone into inversion. Commodities from base metals to crude oil continued their downtrend in spite of China's pledge to meet growth targets. On the currency front, the greenback had initially spiked up, but faded some by month end as investors started to question America's preparedness for COVID-19. Gold at one point surged above $1650 per ounce, but the market's panicked selling at month end took it down to flat for February. With the VIX Index having surged to levels that historically coincided with market troughs, we would expect some stabilization in the near-term. However, markets are likely to be at the mercy of breaking news and the scales of the outbreak. In the end, this too shall pass, but it will test our collective patience and resilience.

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Fall of the Mongol Empire

Pax Mongolica, or "Mongol Peace" in Latin, is a term used to describe the stability and prosperity in the vast Mongol Empire during the 13th and 14th centuries. Mongol nomadic tribesmen, under the leadership of Genghis Khan and his descendants, had created the largest empire in history that stretched from the Korean Peninsula to Budapest, and from Siberia to the South China Sea. While the Mongols were known for their brutality in conquests, they were quite inclusive in leveraging local talent to administer the vast empire. They amalgamated once isolated civilizations into a thriving commercial network connected by the Silk Road. They also created a maritime Silk Road from the South China Sea to the Red Sea. Military garrisons and postal stations were established along the trade routes to ensure that goods, ideas, people, and religions would move smoothly across Eurasia.

As the movement of people and goods increased throughout the Mongol Empire, so did the spread of diseases. In 1334, China's Hubei Province suffered a deadly outbreak of bubonic plague which later spread to the rest of China and significantly reduced its population. In 1335, the bubonic plague traveled westward along the Silk Road and claimed Abu Sa'id, the Mongol ruler of Persia and the Middle East, and his sons as its victims. Abu Sa'id's sudden demise left no heir and triggered a power struggle that eventually undermined Mongol rule in the region.

In 1344, the Golden Horde, the Mongol branch that ruled the northwest part of the empire from Eastern Europe to Siberia, laid siege of the Crimean port city of Kaffa (today's Feodosia on the Black Sea coast) that was controlled by the Genoese. Unbeknownst to them, the reinforcement troop from the east brought the plague and the Mongol army started dying by the thousands each day. Undaunted, the Mongols put infested cadavers in catapults and lobbed them at Kaffa in an attempt to infect the city's defenders. This act was considered the very first instance of biological warfare in history. Unfortunately, it succeeded in spreading the contagion among Genoese troop. In 1347, evacuees from Kaffa sailed to port cities along the Mediterranean coast and carried the Black Death to Europe.

In the ensuing four years, the plague spread its tentacles across Europe and decimated tens of millions. Italian writer Giovanni Boccaccio poignantly observed that valiant men and fair ladies would "breakfast with their kinfolk and the same night supped with their ancestors in the next world." The once thriving Eurasian commercial network disintegrated into isolated and desolate communities. The massive population loss and the economic collapse eventually destabilized the Mongol Empire and led to its downfall. In the end, the mighty empire and its fearsome warriors were no match for the microscopic bacteria.

Source: Bloomberg

Equity Markets Indices[1]	01/31/20 Price	02/28/20 Price	MTD Change	YTD Change
MSCI All Country World	559	513	-8.2%	-9.3%
S&P 500	3326	2954	-8.4%	-8.6%
MSCI EAFE	1994	1810	-9.2%	-11.2%
Russell 2000®[2]	1614	1476	-8.5%	-11.5%
NASDAQ	9151	8567	-6.4%	-4.5%
TOPIX	1684	1511	-10.3%	-12.2%
KOSPI	2119	1987	-6.2%	-9.6%
Emerging Markets	1062	1006	-5.3%	-9.8%

Fixed Income

2-Year US Treasury Note	1.32%	0.92%	-40	-66
10-Year US Treasury Note	1.51%	1.15%	-36	-77
BarCap US Agg Corp Sprd	1.02%	1.22%	20	29
BarCap US Corp HY Sprd	3.90%	5.00%	110	164

Currencies

Chinese Renminbi (CNY/S)	6.94	6.99	0.7%	0.4%
Brazilian Real (Real)	4.28	4.47	4.4%	11.0%
British Pound ($/GBP)	1.32	1.28	3.0%	3.4%
Euro ($/Euro)	1.11	1.10	0.6%	1.7%
Japanese Yen (Yen/$)	108.35	107.89	-0.4%	-0.7%
Korean Won (KRW/$) U.S.	1191.70	1214.50	1.9%	5.0%
Dollar Index (DXY)	97.39	98.13	0.8%	1.8%

Commodities

Gold	1589	1586	-0.2%	4.5%
Oil	51.6	44.8	-13.2%	-26.7%
Natural Gas, Henry Hub	1.84	1.68	-8.5%	-23.1%
Copper (cents/lb) CRB	252	255	1.2%	-9.0%
Index	170	159	-6.4%	-14.2%
Baltic Dry Index	487	535	9.9%	-50.9%

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The Most Cunning Virus

686 years after the 1334 outbreak of the bubonic plague, Hubei province was once again ground zero for an epidemic. It started with a cluster of pneumonia cases of unknown aetiology last December in Wuhan, the provincial capital. Three months later, the SARS-CoV-2 virus has found its way to Iran and Italy, just like the 14th century Black Death but in a much shorter timeframe. In fact, save for Antarctica, the virus has reached all continents.

In our last report, we had opined that, depending on the virus' transmissibility and severity, there is a wide range of potential outcomes with the tail risk of global pandemic. The horrendous news from the Diamond Princess cruise ship, where 705 of the 3700 guests and crew onboard were infected, highlighted COVID-19's highly contagious trait. It is quite difficult to contain the contagion due to its long incubation period and asymptomatic transmission. The SARS-Cov-2 virus can remain infectious on inanimate surfaces such as tables, elevator buttons and doorknobs at room temperature for up to 9 days. Some even suspect that aerosol transmission – contagion through the air by inhalation of infectious particles – is possible.

COVID-19's case fatality rate is estimated at around 2%, which is 20 times deadlier than a typical flu and close to the 2.5% mortality rate of the infamous 1918 influenza, aka the Spanish Flu. Researchers at China's Centers for Disease Control and Prevention (CDC) reported case fatality rate of 2.3% based on findings from more than 72,000 reported cases. The disease hits the elderly and those with pre-existing conditions especially hard. The only "good" news is that 81% of the cases were classified as mild, meaning they had flu symptoms or mild pneumonia. However, some patients who had supposedly recovered from COVID-19 were later tested to be still carrying the virus, and several have relapsed.

Many experts now believe that SARS-CoV-2 is unlikely to disappear in the summer, and that COVID-19 will likely become a global pandemic. As far as treatments are concerned, Gilead Sciences' Remdesivir, a drug designed to treat the Ebola infection, has worked on several patients and the company is currently working on clinical trials with results expected in April. Physicians in Thailand have shown that a cocktail of HIV and flu medications to be effective. There is also a frenetic race around the globe to develop a vaccine, though it may take more than a year to come to fruition for the general public. An effective vaccine may be the only way to deal with COVID-19 given how cunning the virus is – long incubation period with asymptomatic transmission, difficulty in diagnosis (the nucleic acid test for the virus is known to have false negatives), and the possibility of relapse. It will create many challenges to the world's healthcare systems in the coming weeks and months. That said, human ingenuity and resiliency will find a way to cope with it. Unlike the Black Death that inflicted apocalyptical terrors in late Middle Ages with impunity, the SARS-CoV-2 will be defeated by the collaboration of scientists around the globe.

Whistling Past the Graveyard

In a roaring equity bull market where every dip should have been bought over the last eleven years, investors were initially emboldened to look past the COVID-19's potential disruption. Using the SARS crisis of 2003 as a precedent, many market participants believed that the COVID-19 crisis would similarly last for just a few months and then dissipate in the summer heat. Still, it was hard to fathom how the S&P 500 Index could have rallied 5% to the February 19th high in the face of China's unprecedented lockdown. Chalk that one up for irrational exuberance. Undaunted, bullish strategists have stuck to their guns as equities plunged during the last week of February.

Their investment thesis is that central banks will respond to the crisis by flooding the system with liquidity to boost financial asset prices. To wit, one well-respected strategist opined that global fiscal and monetary response will likely outlast the pandemic, and another quipped that investors should "buy the natural disasters, sell the man-made ones."

The issue with the in-the-Fed-we-trust playbook is that monetary stimulus cannot kill the virus, though it does help ease financial conditions. We cannot easily dismiss the tail risk of a recession due to public hysteria and behavioral changes. Japan will close all schools for the entire month of March as failure to contain the outbreak may lead to cancellation of the Tokyo Summer Olympics. Milan's pro soccer team just played a match in front of an empty stadium. Companies such as Amazon, Facebook, Nestle, and Alphabet have pulled out of or cancelled major industry events. The public health risk is especially acute for densely populated urban centers. Travel and hospitality industries have already taken a hit, and the economic damage will likely extend to other sectors when the outbreak goes exponential. As sales and cash flow start to decline, businesses will likely curtail spending and delay investments. This is how a vicious economic cycle gets started, and the traditional circuit-breakers, i.e., monetary and fiscal stimulus, will not have much impact unless the COVID-19 outbreak is arrested.

Balancing Acts

The one positive story that the bulls can point to is the situation in China. Having locked down most of the country through mid-February, China's leadership realized that the economic tolls would be devastating if factories remained closed. They quickly shifted policy initiatives from draconian disease containment to back-to-work mobilization. Miraculously, outside of Hubei province, the rest of China started to report rapidly declining new cases in unison. On the first day of March, the number of new cases in mainland China sans Hubei was just 5. Most cities lowered their health alert levels and urged residents to get back to life as usual. Although investors may not buy into China's rosy statistics, some could nevertheless trade on these numbers.

China's draconian containment measures were indeed helpful in limiting the outbreak, but the country still faces the risk of new rounds of outbreaks as factory workers return to their shops and dormitories. Many firms are struggling with cash flow issues due to extended closure. The COVID-19 crisis will lead to greater concentration of power among China's state-owned enterprises, and inflation may also climb higher due to supply disruptions. Ironically, while many observers fault China's central command structure for its slow reaction to the initial outbreak in Wuhan, Chinese authorities must feel good about their efficient execution of the lockdown measures across the country. As the rest of the world struggles to contain COVID-19 outbreaks, Chinese media and many netizens are having a field day touting with smugness the supposed superiority of their system. Indeed, judging by the various reported issues with our limited COVID-19 test capacity, the U.S. does not appear to be well-prepared at this point.

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Risk-Reward Asymmetry

Equity markets' cathartic selloffs in the last two sessions of February exhibited classic signs of panic and capitulation. If history is any guide, stocks are more likely to mount a rally in the near-term than to collapse further. That said, there is still an asymmetry in the market's risk/return profile. The potential upside is capped by continued downward earnings revisions, but the downside risk is substantial if COVID-19 winds up dragging the U.S. economy into recession. While one can argue for higher valuations based on the collapse of long bond yields and further easing by the Fed, the market's risk premium should also go up to account for the uncertainty associated with COVID-19. Investment is about anticipating future news headlines – how will the market react when people in major U.S. cities are told to work from home and schools are closed to minimize contagion?

Furthermore, we would be remiss not to mention the political ramification of a public health crisis. A big COVID-19 outbreak in the U.S. will likely hurt President Trump's re-election prospects, and his opponents could seize the crisis to highlight America's healthcare issues and the administration's prior cuts to CDC budgets. Some may think that I am too paranoid about COVID-19; after all, the flu kills far more people each year than all the reported deaths from COVID-19 thus far. Well, if COVID-19 were just a bad flu, would the growth-obsessed Chinese policymakers lock down the whole country to contain it?

In the final analysis, we are dealing with a highly unusual situation and we would rather err on the side of caution. We have increased the defensiveness of our managed portfolios and reduced risk. The market pullback is also starting to create more attractive investment opportunities as the valuation excess in parts of the market gets corrected. For those who are prepared, let's close with a quote from Warren Buffett: "Be fearful when others are greedy and greedy when others are fearful."

For more information on Rockefeller Capital Management:

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[1] Index pricing information does not reflect dividend income, withholding taxes, commissions, or fees that would be incurred by an investor pursuing the index return.
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