SPECIAL MARKET UPDATE: BREXIT, CORONAVIRUS, AND 4TH QUARTER GDP
February 3, 2020

Market volatility has been a consistent investment theme of ours now for the past 2 years, and the confluence of last week's headlines has only helped perpetuate the matter, leading to a market decline of 3% since the January 17, 2020 closing high of the S&P500.

While this decline is small in magnitude, especially given the 31.5% return of the S&P 500 last year, and its cumulative 351% return over the past decade, we felt it important to address some of the larger issues impacting the news cycle, and remind our investors that this may prove to be an opportune time to begin to engage in discussions regarding opportunities to take some risk off the table in your investment portfolios.

Coronavirus

The coronavirus first sparked concern following its initial case reported on December 31, 2019. In just one short month, the disease has quickly spread to nearly 20,000 confirmed cases across the globe, with its death toll subsequently eclipsing that of the 2002-2003 SARS outbreak. While a global pneumonia is certainly not a laughing matter, from a financial perspective, the S&P 500 has traded higher 3 months after the World Health Organization (WHO) has announced a global health crisis 7 out of 11 times, and the mortality rate of this strain appears to be significantly lower than that of SARS. The financial impact is likely to revolve around continued manufacturing and supply chain disruptions, and a temporary decline in sales to affected markets. This may even manifest itself through short-term price inflation, like what occurred in the construction industry during the initial stages of the US-China trade dispute. But for long-term investors, such quarterly disruptions are unlikely to have long-standing impacts on the earnings of multinational companies, and even less so on domestic companies (60% of the S&P 500 market-weighted revenues are domestic).

Fourth Quarter 2019 Earnings Season

On the subject of earnings, fourth quarter earnings season has kicked off, with three quarters of those S&P 500 companies that have reported results having topped their earnings estimates. This has caused 4th quarter consensus earnings growth expectations to rise from a previously expected decline of -1%, to a narrower decline of -0.3%. Not great, but directionally better. More importantly, 2020 earnings growth is expected to grow 9.6% for the year, compared to a slight decline of -0.2% in 2019[1]. We still believe more moderate earnings growth will manifest itself throughout the year, leading to positive, yet moderate domestic equity returns for investors. When considering the impact of the coronavirus on

[1] *YRI S&P 500 Earnings Forecast.* Yardeni Research, Inc. January 27, 2020.

earnings expectations, a slightly lower Q1 2020 earnings growth forecast may be a prudent. So far 27 of the S&P 1500 companies have mentioned “virus” or “coronavirus” according to FactSet, with their comments being mostly benign.

Fourth Quarter and 2020 GDP Growth

We do not expect coronavirus to have a material impact on GDP growth. Last week the Bureau of Economic Analysis (BEA) announced fourth quarter GDP of 2.1%, ahead of expectations. This report was a bit misleading, as it was boosted by a decline in imports due to the US-China trade dispute, which hid weakness in consumer spending and business investment. Without this trade boost, GDP would have been closer to 0.6% for the quarter, the lowest level since 2015. Whether or not the aftermath of the recently signed “phase one” trade deal improves business and consumer spending, The Conference Board expects US real GDP growth of 2.1% in 2020, and global GDP is forecast to grow at a healthier 3.3% according to the International Monetary Fund (IMF). Coronavirus is unlikely to materially disrupt this outlook. It would take a loss of $22 Billion in economic activity to move US GDP by 0.1%. Barron’s did a nice job of putting this into perspective by stating that Starbucks loses about $25 million in revenues for every week they are closed – meaning it would take 880 weeks of Starbucks China store closures to shave 0.1% off of US GDP.

Brexit

Of all the issues present in the news cycle, we are perhaps paying closest attention to Brexit. After nearly three years of negotiations, last Friday the United Kingdom officially left the European Union (EU) and will now have to renegotiate its trade agreements. While some speculate a boost from pent up demand to hire and spend following Brexit uncertainty, and additional benefits from a weak currency, the UK is the first to leave the EU, and with 49% of their trade to EU countries, a no-deal outcome could lead to trade disruptions, lower global GDP, and harm US companies (mainly financial services) that have invested hundred of billions of dollars in the UK as a mechanism of accessing the EU. The UK have until the end of 2020 to reach a trade agreement.

Outlook and Tactical Hedging

Despite these headlines, we remain confident that 2020 will be a moderately positive year for investors, driven by ~2% US GDP growth, mid to high single digit earnings growth, muted inflation, and accommodative global central bank policies. In fact, on Friday afternoon, in the face of the coronavirus epidemic, the Peoples Bank of China announced a ~$22 Billion injection of capital to stimulate the local economy in advance of the expected market sell-off following the return from the Lunar New Year holiday. And more importantly, our own US Federal Reserve has expanded its Balance Sheet by $390 Billion since September, driving liquidity into the markets, stimulating business and consumer investment in the economy, and supporting equity markets.

We believe this is now an opportune time for investors to consider implementing hedging across their investment portfolios, while still maintaining equity exposure. For many of you, the incorporation of Structured Solutions across your equity allocations may provide an attractive means of balancing risk and reward. For others, a shift towards the lower range of your target equity allocation, with the balance of the proceeds reinvested in short-term fixed income may be more appealing. Regardless of the approach, we will be reviewing your individual accounts, and, if applicable, considering whether accelerating the realization of your 2020 capital gains in the first quarter, and rebalancing your portfolio makes the most sense at this time. We will reach out directly to discuss how this impacts your individual portfolios.

In the interim, if you have any questions or concerns, or would simply like to discuss this or any other issues further, please do not hesitate to call us anytime.

Looking forward to speaking soon,

Brian Luster
Principal and Chief Investment Officer
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