Market INSIGHT

Berkshire Bank WEALTH MANAGEMENT

An Infection Inflection Point

by Charlotte Irwin, Vice President, Portfolio Manager

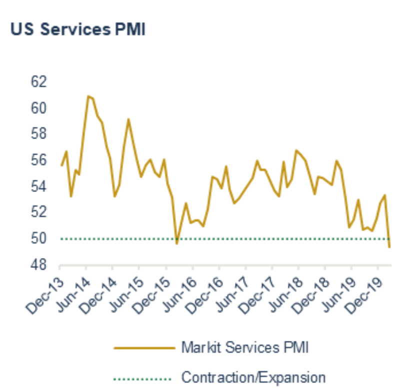
The World Health Organization (WHO) has declared a global health emergency over a new strain of coronavirus, now known as COVID-19. The virus originated in the Chinese city of Wuhan, where authorities first alerted the WHO to several cases of unusual pneumonia on December 31 of last year, and as of this writing has since infected more than 80,000 people in 38 countries – with a death toll of over 2,500.

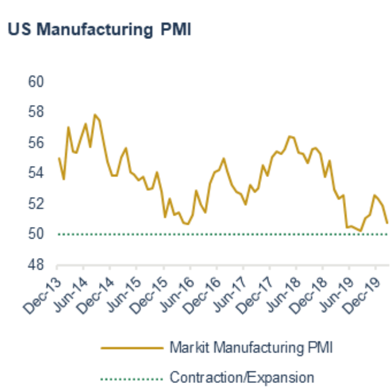
Despite the virus's continued momentum, until recently investors had been sanguine as to its economic impacts, anticipating either that its effects would be temporary or that policy makers would step in to provide additional liquidity – as they have throughout the post-crisis bull market. While cases spread, these beliefs fueled growing signs of complacency in the market. On February 19, the S&P 500 closed at a record high of 3,386.15, implying a forward 12-month P/E of 19.0, its highest level since May 2002[1]. With investors piling into richly valued equities, cash comprised only 4% of portfolios, the lowest share since March 2013, according to Bank of America's February global fund manager survey.

Something had to give, and on February 24th it did. The S&P 500 fell more than 3%, registering its largest single day decline in two years, as major global equity benchmarks slid amid a flight to higher quality assets. Markets have continued to slide for several days, with US equities entering a technical correction on February 27th, as the US 10 Year Treasury yield slid to record lows. Such moves were not confined to the US, as global curves flattened aggressively, and the global stock of negative yielding debt rose back above $14 trillion.

These single day moves were likely exacerbated by timing, with news of outbreaks in South Korea and Italy breaking over the weekend as markets were closed, though they reflect, in our opinion, a rightful recognition of the severity of the virus and its potential impacts on global growth and supply chains. While trade tensions between the US and China have weighed on the manufacturing sector, the virus is impacting the until now resilient services sector – which comprises roughly two thirds of the US economy. Tellingly, in February the IHS Markit flash services sector PMI slipped into contraction for the first time since the global growth slowdown in 2016, with the new business index dropping to its lowest level since 2009.

Measuring the scale of the virus's economic impact is challenging. The International Monetary Fund (IMF) has said the virus will likely reduce global growth by 0.1% and Chinese growth by 0.4%, though they admit that they are "also looking at more dire scenarios where…the growth consequences are more protracted." In China, the world's second largest economy and epicenter of the outbreak, data releases can be spotty, and initial impacts were masked by the Lunar New Year holiday, when the Chinese economy typically grinds to a halt. Alternative data sources such as passenger traffic volume, power production, property sales, and road congestion show that activity has not rebounded as hoped. Airports, shopping malls, and factories remain shuttered as authorities seek to contain the spread of the epidemic. The recent acceleration of the virus outside of China compounds these risks.





Source: Berkshire Bank Wealth Management, FXStreet, as of February 25, 2020

[1] FactSet Earnings Insight

Given how important China is not only in global supply chains, but increasingly as a source of global demand, this poses a risk to the performance of a wide range of firms. Airline bookings have seen the biggest-ever single event reduction in activity, retailers from Apple to Starbucks remain closed, and Maersk has canceled more than 50 trips to and from Asia where they derive more than 30% of their business. These firms are only a handful of the many who have begun to warn of the potential financial impacts of a protracted slowdown, as analysts have begun to trim their 2020 earnings and sales forecasts.

Portfolio Implications

While much remains unknown about the virus, we know that it has increased uncertainty in the near to medium term. The impacts will be particularly acute for some industries, such as travel and tourism, but the exact geography and severity of the virus's spread, as well as the varied nature of governments' response to containment and prevention will create uneven, idiosyncratic impacts. Given that each firm's supply chain is unique, assessing and pricing risks related to the virus will be most effectively done on a company specific basis.

In an already low-yield environment, sustained risk-aversion may further depress yields. The US 10-2 Year yield curve, a common recession indicator, is likely to remain positive, yet range bound between 10-25 bps.

In the fixed income market, a historically flat yield curve and tight spreads lead us to believe that investors may not be compensated for taking on interest rate and credit risks. In response, our portfolios are generally underweight duration and overweight quality relative to their benchmark. In equities, we continue to seek companies with strong balance sheets, with a heightened emphasis on strong, consistent dividend yields.

We are in an extended economic cycle, and an election year. Given the historically high valuations for both equities and fixed income leading into this period, volatility was to be expected. Such periods stress the importance of solid long-term financial planning and a disciplined approach to portfolio rebalancing. A diversified, quality driven portfolio tailored to an individual's risk tolerance and time horizon remains the most prudent investment approach.