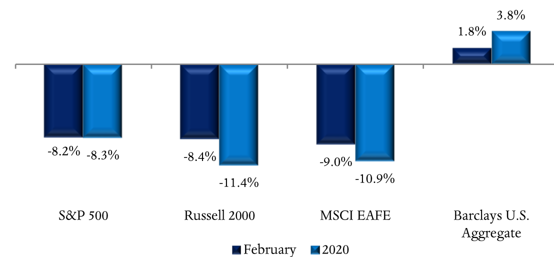
PAPAMARKOU WELLNER
ASSET MANAGEMENT, INC.

February / March 2020 Issue # 202

Markets



After initially shrugging off concerns, the spreading of the Covid-19 coronavirus, both inside and outside of China, became the main investor focus in February. Fear of the unknown effects on the global economy and the potency of the virus sent equity markets reeling, culminating in seven consecutive days of selling, with a rapidity that has only occurred four other times since WW II. On the last day of February, the VIX volatility index reached a peak of 49.5, an extreme reading only surpassed a handful of times over the past two decades. For the month, the S&P 500 index declined -8.3% (-8.3% ytd), while the smaller capitalization Russell 2000 index tumbled -8.4% (-11.4% ytd). Overseas stock markets behaved similarly, with the MSCI EAFE index declining -9.0% (-10.9% ytd). In Europe, the Stoxx 600 retreated -8.3% (-9.4%). Similarly, Japanese equities pulled-back -8.8% (-10.6% ytd). Chinese stocks were more resilient as seen by the Shanghai index (-2.2% in February; -5.3% ytd), perhaps focusing on the stabilization of local coronavirus cases and more positive times ahead.

Fears of near-term negative effects on Chinese and global growth, together with the expectation that central banks around the globe will provide further monetary policy support, sent government bond yields lower throughout the month. The US 10-year Treasury yield closed at a new all-time low of 1.1%, 2.1% points below the peak in October 2018. For February, the Bloomberg Barclays US Aggregate bond index rose +1.8% (+3.8% ytd).

Risk aversion also spread to commodities. The WTI crude oil benchmark declined a further -13% during the month (-27% ytd). The energy market witnessed the first decline in global oil demand since 2009, due to the economic disruptions caused by the coronavirus outbreak, together with stalling negotiations between Russia and OPEC on the implementation of further supply cuts. General commodity weakness sent a disinflationary impulse through the global economy, leading central bankers and politicians to signal that supportive monetary and fiscal measures were coming. The environment of ultra low interest rates and a risk-off financial market psychology highlighted the stability of gold (-0.3% in February; +4.5% ytd).

Geopolitics

The whole world is following the spread of the Covid-19 coronavirus. Over the course of February the number of reported cases more than tripled, reaching 67 countries, with the health of thousands at risk. In addition to China, there have been severe outbreaks in South Korea, Italy, and Iran. As a result, citizens are being cautious with regard to interaction with others, travel is being curtailed, and businesses are having to adjust in a variety of ways. There have been cancellations of conferences such as the Geneva Car Show, the Mobile World Congress in Barcelona, and the Tokyo Summer Olympics may not take place as planned. Of some solace, the progression in China (culminating in the recent slowdown of new cases), and one month lead time, provides an important roadmap allowing other countries to prepare.

In the US Presidential election's battle for the Democratic nomination, Bernie Sanders took the initial lead after a strong showing in the first three primaries. However, the recent Super Tuesday (where 12 states went to

the polls) favored former Vice President Joe Biden. Thus, the odds of a more centrist Democratic nominee have increased substantially.

United States

Economic data in the US was mixed in February. Low mortgage rates continue to fuel activity in the housing market, with starts and permits ahead of expectations amid continuing home price appreciation. The most recent employment report revealed a healthy labor market, with solid job gains, additional workers joining the work force and solid year-over-year wage gains of 3.0%. Total payroll employment rose by 273,000, and the jobless rate ticked down to 3.5%. It is, however, important to note that this data precedes the corona-virus worries. Milder than normal weather provided a tailwind, particularly in construction. On the other hand, industrial production showed a second consecutive monthly overall decline into contractionary territory, while manufacturing rested just above the expansionary 50 level. Moreover, the spreading of Covid-19 within the US is beginning to impact consumer confidence and business sentiment.

While recent hard macro data indicates that the underpinnings of the US economy remain healthy, there is economic downside risk if Covid-19 can't be contained. This has already prompted further monetary stimulus by the Federal Reserve, in the form of an intra meeting 50 basis point rate cut, with markets pricing significant additional near-term reductions.

Europe

Although the eurozone economy ended 2019 on a weak note, early-2020 highlighted some green shoots, which are likely to be temporized by the spreading of the coronavirus. The eurozone composite PMI rose 0.3 points to 51.6 in February, which is consistent with on-trend GDP growth (which has averaged 1.9%, for the region, over time). The rebound reflected the fading of various headwinds such as the trade war, uncertainty over Brexit, the auto emissions scandal, and a sharp inventory correction. Notably, there was a boost in the region's manufacturing, notably in Germany. However, forward looking surveys indicate the potential for a significant impact from Covid-19, with sharp declines in the PMI sub-component for export orders, and a sudden lengthening of delivery times. These virus-related drags are likely to intensify further as the outbreak in Italy and the surrounding region sap demand and disrupt production. The globally-integrated European economy is vulnerable to supply chain disruptions, posing downside risks to growth.

February 2020 Economic Statistics

	Feb-20	Dec-18	Dec-17
Federal Funds Target Rate	***1.50-1.75%***	2.25-2.50%	1.25-1.50%
Consumer Confidence Index	***130.7***	128.1	122.1
Manufacturing PMI Index	***50.1%***	*54.1%*	59.7%
Unemployment Rate	***3.5%***	*3.9%*	4.1%
JPY/USD	***108.07***	*109.56*	112.67
USD/EUR	***1.1025***	*1.1469*	1.1996
Gold/oz.	***$1,584.74***	*$1,282.73*	$1,302.45
Oil (WTI)/bbl	***$44.76***	*$45.41*	$60.42

If the economic situation deteriorates further in the coming months, additional monetary as well as fiscal measures can be expected. We would look for Germany to soften its government spending limits, as a first step. Markets also expect the ECB to further encourage bank lending and reduce interest rates, albeit slightly, given the already negative levels and prevailing QE program, perhaps complicated by the ECB's ongoing central bank policy review.

UK economic sentiment continued to improve in February, on both the consumer and business fronts. In hindsight, job growth persisted with a solid 180,000 gain in the three months leading up to year-end, with the unemployment rate at 3.8%, the lowest level since 1975. The country is also likely to suffer a reduction in confidence and activity from the virus outbreak, and markets have priced in an interest rate cut, to a record low 0.5%, at the next policy meting of the Bank of England. On the Brexit front, the UK government and the EU published their respective directives for the trade negotiations, which will start later this month.

Asia

The coronavirus outbreak has proven to be a large shock to the Chinese economy, with trickle-down effects on the global supply chain. Preventative measures, that would be un-thought-of in western countries, have led local authorities to implement significant restrictions on mobility and working conditions. As such, rapid-action economic indicators such as daily energy consumption haven't show the typical rebound that usually follows the Chinese New Year, remaining circa -30% below typical seasonal levels. Clearly China's economic growth will slow sharply in the first quarter, but should rebound in the intermediate term as life normalizes, which already appears to be happening.

Chinese policymakers have responded to the economic retrenchment with several supportive measures. The People's Bank of China cut their prime rate by 10 basis points. Provincial governments waived VAT, social contributions and rent, to ease the financial pain, particularly for smaller businesses. A slow and gradual economic rebound is the most likely scenario given recent trends in production and the uncertainty around the extent to which consumer psychology has been damaged.

Japan's economy was expected to contract in Q4 of 2019 after a sales tax hike in October, but data released in February showed GDP dropped -1.6% (a seasonally adjusted annualized rate of -6.3%), much more than market expectations and at a worst pace than what followed the previous VAT hike in 2014. In addition, exports fell for the 14th consecutive month year-over-year. With Covid-19 expected to hit Japan's inbound tourism (they are expected to host the summer Olympics this year) and trade, the risks for the Japanese economy have risen.

In Korea, the country with the most confirmed Covid-19 cases outside of China, consumer confidence fell from 104.2 in January to 96.9 in February, the largest single month decline since June 2015. Coupled with the close economic relationship between Korea and China, local GDP may be reduced by 1.0% in 2020.

Outlook

Investors entered the year in an ebullient mood, arguably complacent, as seen by i) surveys that indicated equity portfolio cash levels were near a seven-year low, ii) short interest on the S&P 500 ETF at the lowest level since 2007, and iii) option trading of calls 60% higher than any period since 2000. Concurrently, the Federal Reserve reduced the amount of repurchase (repo) agreements outstanding (from $256 billion at the start of the year, to $126 billion at the end of February) more than offsetting the $60 billion of monthly monetary flows into the financial system. As a result, the market had little buying support left upon the realization that the Covid-19 virus may have greater global economic repercussions than initially thought. The coming price discovery process may take several more months to clear, during which time investors should focus on medium to long term fundamentals, which appear to be generally intact. Currently the S&P 500 index is trading at 16.8x 2020 earnings expectations, which call for a -5% decline from the prior year.

Looking ahead, interest rates should continue to be supportive of equities, as US Treasury yields have tumbled to record lows, all along the yield curve. Further, the Federal Reserve reduced short-term rates intra-meeting in early March and market expectations call for additional cuts, potentially leading to zero-bound yields in the coming months. Foreign central banks have also indicated their willingness to provide ample liquidity to the financial system, starting with China, with others following suit. As a result, European sovereign bonds yields have dropped deeper into negative territory. While government bonds may provide stability and diversification, we continue to recommend exposure only in short maturities. In terms of risks, credit spreads could widen further, with high yield bonds most at risk.

Alternative strategies have fared well on a relative basis thus far in 2020, in many instances producing positive absolute returns. With the ability to act swiftly and hedge against market declines, select alternatives have the potential to increase diversification and dampen the volatility of traditional portfolios, while producing attractive returns.

Important Disclosure and Terms of Use: Property of Papamarkou Wellner Asset Management, Inc. For targeted distribution only and not a solicitation. This report may not be displayed, reproduced, distributed, transmitted, or used to create derivative works in any form, in whole or portion, by any means without express written consent by Papamarkou Wellner Asset Management, Inc. or its operating subsidiary, Papamarkou Wellner & Co., Inc. MEMBER: FINRA/SIPC. All opinions expressed within unless otherwise stated are those of Papamarkou Wellner Asset Management, Inc. based on the most recent market, security, and economic data available.

Sources: Barclays, Bloomberg, Bureau of Labor Statistics, Conference Board, Department of Agriculture, Federal Reserve, Financial Times, IMF, Institute for Supply Management, MSCI, Reuters, Russell, Standard & Poor's, and the Wall Street Journal

430 Park Avenue · 17th Floor · New York, NY 10022 Tell (212) 223-2020 · Fax (212) 758-9804 · www.papamarkou.com