

The Year of the Virus

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2020 has quickly become the year of the virus.

It should, of course, first be recognized that, for some families around the world today and, sadly probably many more in the months ahead, issues of economics, politics and finance will be but a small footnote to personal tragedy. That being said, after an historic tumble in stock prices and interest rates last week, investors in the week ahead will be trying to assess what the coronavirus outbreak means for their investments.

Such an assessment should begin by looking at the disease itself and considering the difficult questions of its potential human toll and how quickly it can be contained. Then it is important to consider how both personal decisions and governmental restrictions in reaction to the virus could impact the global economy. Another key issue will be the monetary and fiscal policy response both here in the United States and around the world. Political considerations may also be important, as the fallout from the virus has the potential to impact the November election and any subsequent policy changes. Finally, investors will be keenly interested in when the stock market might be expected to hit bottom and begin to recover.

On this last question, however, it is crucial to focus on valuations and recognize that the value of long-term assets depends on *long-term* economic performance. 2020 may be the year of the virus but the value of bonds and particularly stocks depends only to a small extent on current year and much more on what happens in the years and decades ahead. The most important question in personal investing is never “when” but rather “what”, and investors should consider whether their portfolios are constructed both to weather the problems of 2020 but also to benefit from an inevitable rebound as the calendar moves forward.

First, on the disease itself.

As of February 29th, according to the World Health Organization^[1], there have been over 85,000 cases of the Covid-19 virus confirmed worldwide. Of these, roughly 79,000 have occurred in China and 6,000 elsewhere.

It is too early for health authorities to precisely estimate the overall mortality rate from the disease. However, it is notable, even in the early stages of the outbreak, that the disease appears to be far more deadly for older people, particularly those with some other underlying ailment such as heart disease or respiratory problems. A Chinese study published on February 11th

looking at over 44,000 confirmed cases of COVID-19, showed a crude mortality rate of 0.2% for those under the age of 40, 0.9% for those aged 40 to 59 and 6.0% for those over the age of 60.

To put this in perspective, the coronavirus is clearly more lethal than a typical influenza outbreak which has a mortality rate of less than 0.1%. However, it appears to be much less lethal than some other recent viruses such as Ebola, which killed roughly 90% of those infected, SARS which had a mortality rate of 11% or even the huge Spanish Flu pandemic of 1918, which killed 2.5% of those who contracted it.

It is also too soon for authorities to tell precisely how contagious the virus is. However, the World Health Organization has issued a preliminary assessment that the average person with COVID-19 can infect between 1.4 and 2.5 others, making it more contagious than, for example, most forms of influenza. Because of a long incubation period, the possibility of asymptomatic transmission, and the mildness of symptoms for many of those who come down with the disease, it appears likely that total cases will increase rapidly in the weeks ahead. One key unknown is whether this virus will fade in the spring as is often the case with viruses. However, even if this did occur in the northern hemisphere, the global nature of the spread of the disease suggests that it may become a more permanent global threat.

Finally, the medical community around the world is racing to produce a vaccine. While technology in this area has improved dramatically in recent years, any vaccines produced will have to be tested for safety and effectiveness, may have to battle future mutations in the virus itself, and would need to be manufactured on a massive scale. This suggests that the world may have to wait for many months, if not years, for a full medical response to the outbreak.

Over the past few weeks, as these facts have become clearer and the global spread of the virus has increased, the economic consequences have also come into sharper focus. Travel and entertainment industries are the most vulnerable, with significant declines in airline travel, hotel and cruise bookings, casino traffic and general tourism, particularly in regions with confirmed outbreaks. In addition, while Chinese manufacturing is ramping back up following contagion-related shutdowns, some continued disruption to global manufacturing is likely. Sharp stock market declines could add to consumer caution while, on the business side, the outbreak is creating uncertainty which should slow both hiring and capital spending. While some niche industries may benefit from the demand for medical supplies and needs created by “social distancing”, in general the virus should slow economic growth.

For the U.S. this could cause analysts to pencil in very low economic growth for a few quarters or even a decline in output. For the rest of the world, it should delay the rebound that was expected following a relaxation of trade tensions entering the New Year.

Monetary and fiscal authorities will likely respond with further stimulus, both to fund efforts to combat the virus and to bolster demand more broadly. Fiscal stimulus in the form of tax cuts outside the United States could soften the impact of the slowdown. Meanwhile, on Friday, Jay Powell released a very short statement noting that the Federal Reserve is “closely monitoring developments (related to the coronavirus) and their implications for the economic outlook” and

that they will "...act as appropriate to support the economy". This would seem to suggest high odds of a rate cut at their March 17-18th meeting, if not before. It should be noted that a rate cut would be very unlikely to bolster economic activity. However, it could further diminish the attractiveness of bonds and thus help support the stock market.

It is also not clear what any of this will mean for U.S. politics.

Following a big win in South Carolina, former Vice-President Joe Biden has momentum going into Super Tuesday when just over a third of the pledged delegates to the Democratic convention will be chosen in 14 states. A potentially big win in California should leave Bernie Sanders as the delegate leader. However, other contests are likely to be closer and, given the proportional allocation of delegates among candidates receiving over 15% of the vote, the nomination race should still be very competitive following Tuesday, particularly if other moderate candidates drop out.

Who the Democrats choose as a standard-bearer in November will be important not just in winning the White House but in the potentially even more difficult task of holding onto the House of Representatives and regaining control of the Senate. Any sense that the Administration is bungling the response to the outbreak or an actual U.S. recession would likely reduce the President's chances of being re-elected.

And so finally, what does all of this mean for investors?

It is important to acknowledge that both uncertainty and economic weakness are negatives for the stock market and positive for bonds. However, market movements in recent days have arguably priced much of this in. In particular, the P/E ratio on the S&P 500 has fallen sharply and is now just 16.6 times next year's earnings compared to a 25-year average of 16.3 times while the yield on a 10-year Treasury bond has fallen to an all-time low of 1.13%.

While it is impossible at this time to judge the full extent of the damage that will be inflicted by the virus, it is more reasonable to consider how long that damage will last. Even if the virus were to spread much more generally, those who are either less nervous or less vulnerable to its effects would likely try to get back to normal. The distribution of an effective vaccine in the next year or 18 months would obviously help the world economy back on its feet, while even the news that such a vaccine was being produced should help global stock markets.

No doubt stock market valuations were on the high side before news of the virus worsened and this may have contributed to the size of last week's selloff. But it is important to once again consider the meaning of valuations. The only thing that makes a stock valuable is future earnings. If the price on a stock is 16 times the earnings expected over the next year, then that means that next year's earnings account for just 1/16th of the value of the stock. The other 15/16ths of the value does depend on earnings – but not next year's earnings. Rather it depends on earnings in the following year and the year after that and years and decades into the future.

Looked at from this perspective, while 2020 is the year of the virus, the value of a portfolio will largely be determined by what comes next. For investors, this means looking at how well companies and sectors can weather what may be a difficult year but also how they can perform when the virus is no longer an important issue shaping the economic outlook.