



A&I FINANCIAL SERVICES LLC
Optimizing Assets and Income

A&I Financial Services LLC | 9800 Mt. Pyramid Court, Suite 450 | Englewood, CO 80112
303.690.5070 **phone** | 303.699.8945 **fax**
www.AssetsandIncome.com

An Update on the Coronavirus and Equity Markets

The coronavirus outbreak is still progressing and its full health and economic impacts are clearly not yet apparent. We should all have more clarity over the next few months.

We are hopeful the global health authorities can contain this outbreak. China took extraordinary efforts, including shutting down travel and quarantining an entire province. Its response has been much faster than in past epidemics emanating from its shores. Our confidence is bolstered by the prospect of global cooperation. Our hearts and thoughts are with the families of victims, those infected, and those battling the spread of the disease.

The spread in China seems to have meaningfully declined, with daily cases having peaked earlier in February. Concerns now turn toward the spread outside of China. The virus has broken quarantine and is spreading notably in Korea, Europe, and here in the United States, which hits close to home. We are all affected by the personal fears we have for family, friends, and ourselves. But everything we read suggests that thankfully the coronavirus is much less dangerous than other epidemics over the past 20 years.

In terms of the economic impact, it now seems likely the coronavirus—and the global containment measures in response to it—will have a larger negative shorter-term impact on the global economy than our base case a month ago. We can't rule out the potential for the virus to trigger an economic recession, even if the odds are still low. But assuming this doesn't escalate further and turn into a severe global pandemic, the effect on the global economy seems likely to be relatively short-lived—maybe a one or two quarter hit, followed by a make-up period of several quarters of above-normal growth. It is unlikely to have a lasting, long-term effect on the global economy, but it would cause a delay in the current nascent global recovery.

In terms of the financial market impact, history suggests that equity markets should start to rebound once the global rate of daily new virus cases peaks and starts to decline. That said, there could be more downside. If the virus news gets worse, it could lead to a sharper short-term drop in stocks and even a bear market. While the markets fell in February with great speed, it's important to remember that U.S. stocks were up more than 3% year to date at the peak in February and up over 30% last year. That is the unusual occurrence, not the recent price correction, which is quite common historically. It is relatively normal to see 10- to 15-percent declines happen in the stock market about once a year. Furthermore, our portfolios were already prepared and positioned for the possibility of stock market volatility before the coronavirus, with our overall equity underweight and our allocations to defensive and lower-risk asset classes.



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Although we had been assuming a potential correction or bear market within our five-year market projections, it's unfortunate this is coming from the virus. We have often said we didn't know what could cause volatility—and we don't need to predict it. It could have easily been one of the many other risk factors—trade wars, political uncertainty—not to mention the very high U.S. stock valuations coming into 2020. Frequent and sometimes steep declines are the price we must pay in order to earn long-term gains as equity investors.

Tactically, it's not prudent to try to sidestep a market decline or a recession based on a prediction that is very difficult to get right. Instead, as valuation-based investors, we view large declines as opportunities to add back to stocks at attractive prices. If the correction continues, while it may be uncomfortable, we will be assessing whether it makes sense to increase our portfolio allocations to stocks, which we know can pay off handsomely for investors who stick to their discipline through volatile market environments.

Bottom line: Based on what we currently know, we do not believe this event changes our medium- to longer-term scenarios nor the key underlying assumptions for our expected return estimates for stocks and bonds. Therefore, we are not making any portfolio changes in response to the coronavirus at present. Markets have successfully weathered several outbreaks in the past, including SARS, MERS, swine flu, and bird flu. During most of these, the stock market generated a decent return in the 12 months after the outbreak. However, we continue to follow daily reporting on the trajectory and spread of the virus and other developments. If the facts and circumstances change, our analysis and views on the economic and portfolio impact may change as well.

If you have more questions or any concerns, please feel free to reach out to A&I Financial Services LLC to discuss your situation and investment objectives.

Best regards,

Karl Frank and Litman Gregory