Gerry's Journal

February 27, 2020

Coronavirus Situation Outbreak Reaches a Tipping Point

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Just slightly more than three weeks ago, in my inaugural February 3rd edition of "Gerry's Journal" entitled "the Good, the Bad and the Ugly," I provided a brief overview of what the Coronavirus is and what the potential implications are for the capital markets. On that day, the S&P 500 closed at just under 3,249. Up until Monday, February 24th, the S&P 500 seemed to dismiss the concerns raised by myself and several others and moved upwards closing on February 19th at an all-time high of 3,386. This translated to a gain of nearly of 4.2% during the intervening period. Fast forward to the beginning of this week. In just three days, we witnessed a sudden and dramatic retracement of –9.6% from the February 19th all-time high. Notwithstanding the vertigo inducing price action, it is important to note that from the original date of my February 3rd Journal, this represents a decline of just -5.8%.

The reason for the quick refresher on what the capital markets[1] have done during this period is to provide some important context. While some in the media would like to merchant in fear and describe this as an end of days extinction level of event, it is important for us to maintain some perspective. As fiduciaries for our clientele and as patient long-term investors, we don't have the luxury of allowing ourselves to emote and in turn, overreact to prophesies of doom and gloom. To be clear, the spread of the Coronavirus is bad and appears to be getting worse. This will unfortunately, result in a greater loss of life than originally hoped. In an effort to contain the outbreak, countries throughout the world are imposing an increasing number of restrictions on the activities and movement of their citizens and/or interaction with populations that are thought to be at higher risk of infection from the Coronavirus. This in turn, will lead to negative economic effects that, depending upon the severity of this outbreak may result in a contraction of global GDP. The worst effects will likely be felt by countries such as China. As you might imagine, the economic impact of this outbreak is going global. Even if one assumes that the virus will be contained (which is proving to be unlikely), we have already witnessed significant interruption in supply chains that affect the manufacture and supply of products throughout the world.

Before we reach for the arsenic or go into an extended period of self-imposed isolation, let's take a few minutes to reflect objectively on what has happened and what will likely occur next. It is important for us to understand what caused the capital markets to seemingly turn on a dime and move from discounting this as a relative non-event to now recognizing the spread of the virus as a major concern.

First, let's review definitions of certain words that have already become ubiquitous in the media dialogue and will likely get even more attention as the Coronavirus situation progresses.

[1] It is important to note that the S&P 500 is just one proxy for the capital markets and is predominantly comprised of large US companies. As investors we participate in the global markets and in companies of various sizes (capitalizations). In addition to equities, we also invest in fixed income (aka bonds). Nothing contained herein should be construed as suggesting that the only markets of importance are the US large cap equities.

- Epidemic- this term is often used to describe any problem that has grown out of control. An epidemic is defined as "an outbreak of a disease that occurs over a wide geographic area and affects an exceptionally high proportion of the population."
- Pandemic- In contrast, the term pandemic generally relates to geographic spread and is used to describe a disease that affects a whole country or the entire world. While these definitions suggest that there is a specific threshold by which an event is declared an outbreak, epidemic, or pandemic, the distinction is often blurred, even among epidemiologists.
- Capital Market Correction- A Correction is defined as a decline of 10% or greater in the price of a security, an asset, or a financial market. Corrections can last anywhere from days to months, or even longer. While damaging and disconcerting in the short term, a correction can be healthy. Corrections serve to adjust overvalued asset prices and provide buying opportunities. Stock market corrections occur, on average, about every 8 to 12 months and, on average, last approximately 2 months.
- Bear Market- This is a condition in which securities, assets, or financial markets' prices fall 20% or more from their highs. As you might imagine, these declines occur amid widespread pessimism and negative investor sentiment.

This brings us back to the question of what happened on February 24th and why did the markets go from discounting Coronavirus as a non-event to being concerned?

While it would be the height of hubris to suggest that we know all of the reasons that the market has moved so swiftly since that time, the change in market sentiment coincides with when new data was released showing the spread of the Coronavirus to Italy and Iran as well as a significant uptick in the rate of the number of cases in South Korea.[2] The Malcolm Gladwell tipping point for the markets appears to have been when the perception of the Coronavirus morphed from being an epidemic primarily impacting China to a pandemic that will have potentially broader and longer implications for the globe.

Pandemics are not without precedent. As notable health situations such as influenza become more virulent year after year, public health officials will commonly refer to the seasonal outbreaks as pandemics. A recent example of this was the 2009 H1N1 outbreak in the United States in which over 60 million Americans were affected, resulting in 274,304 hospitalizations and 12,469 deaths.[3]

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[2] For the latest infection statistics, please refer to WHO Situation Report 36. https://www.who.int/docs/default-source/coronaviruse/situation-reports/20200225-sitrep-36-covid-19.pdf?sfvrsn=2791b4e0_2.

[3] Centers for Disease Control and Prevention. 2009 H1N1 Pandemic (H1N1pdm09 virus). Updated June 11, 2019.

Notable Pandemics in History

In addition to **HIV**, which has killed over 39 million people since 1982, there have been other equally devastating pandemics in history:

The Plague of Justinian of 541 A.D. was attributed to the bubonic plague and wiped out 25-50 million people in one year. *Ancient History Encyclopedia. Justinian's plague (541-542 CE). Updated December 26, 2014.*

The Black plague killed more than 75 million people from 1347 to 1351, if the count includes those who died in Middle Eastern lands, China, and India, in addition to Europe. *New World Encyclopedia. Black death. Updated September 3, 2019.*

The Spanish flu pandemic of 1918 killed well over 50 million people in one year, including 675,000 Americans.

The smallpox pandemic of the 20th century claimed between 300 to 500 million lives. Edward Jenner confirmed that cowpox provided protection against smallpox infection in 1798. In 1959, the World Health Organization (WHO) launched a huge campaign to globally eradicate smallpox. In 1980, smallpox was declared eradicated - the only human disease that has been eradicated to date. *Centers for Disease Control and Prevention. 1918 pandemic (H1N1 virus). Updated March 20, 2019.*

The ongoing tuberculosis pandemic continues to kill over 1.5 million people annually. Despite the availability of the effective treatment, multi-drug resistance has staved efforts to reverse the progression of the pandemic.

It is not my intention to provide an exegesis on pandemics and epidemics. The reason to draw the contrast gets back to the question of how severe the Coronavirus situation is going to become and what the impact will be on capital markets. While I am not qualified and will defer to those who are to officially declare the Coronavirus situation a pandemic, we can certainly infer from the information that is available that the toll as measured in loss of life and the negative economic impact will be longer and more severe than what we collectively would have preferred. Drawing upon the definitions referenced above, while the S&P 500 has not yet entered "correction" territory, it is extremely likely that it will in the immediate future. As alluded to above, it is crucial to remember that whatever the cause, corrections are normal and are to be expected as part of the ebbs and flows in capital markets.

Investors' anxiety is also reflected in bond markets, where the yield on the U.S. 10-year Treasury dipped to 1.312% on Wednesday, February 26th before trading at 1.34%. As of Thursday, February 27th the U.S. 30-year Treasury is trading at 1.812%. This compares to the dividend yield on the S&P 500 of 1.9%. Prior to this week, there have only been two times in the past decade when the S&P 500 yielded more than the 30-year Treasury (March, 2009 and August, 2019). When this has occurred, subsequent returns in the S&P 500 have been compelling. While there is no guarantee that this will occur in the future, the current market volatility may prove to be an attractive entry point. With that said, we are not recommending that you load up on equities now. The situation will likely get worse before it gets better.

Conclusion

At this point, the answer to the question as to what I should do with my portfolio (or one that I am entrusted to oversee) is as follows:

- Do not panic! Throughout modern history we have seen many difficult fact patterns, from pandemics to world wars. It never serves anyone any good to panic.
- Review your target asset allocation with your advisor. Decisions on how much to be invested in equities should be driven primarily by long-term strategic considerations such as your ability to assume risk and your willingness to assume risk. If you are over-allocated to equities, this could be an opportunity to trim some of those excesses. Conversely, if you have been under-allocated to various asset classes (both domestic and international), current volatility may present an opportunity to add to those portions of your portfolio that are currently under-represented.
- Take advantage of techniques such as dollar cost averaging into the market. No one is clairvoyant and attempting to time the market to get in at the proverbial low or get out at the proverbial top is a fool's errand.
- A corollary to the bullet point on dollar cost averaging is the following: Do not attempt to aggressively trade a volatile market. Trying to time the market usually ends up in tears.

As always, we are here for you. Please let us know if you have any questions or concerns.

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