The Coronavirus and the Markets: A Situation Update

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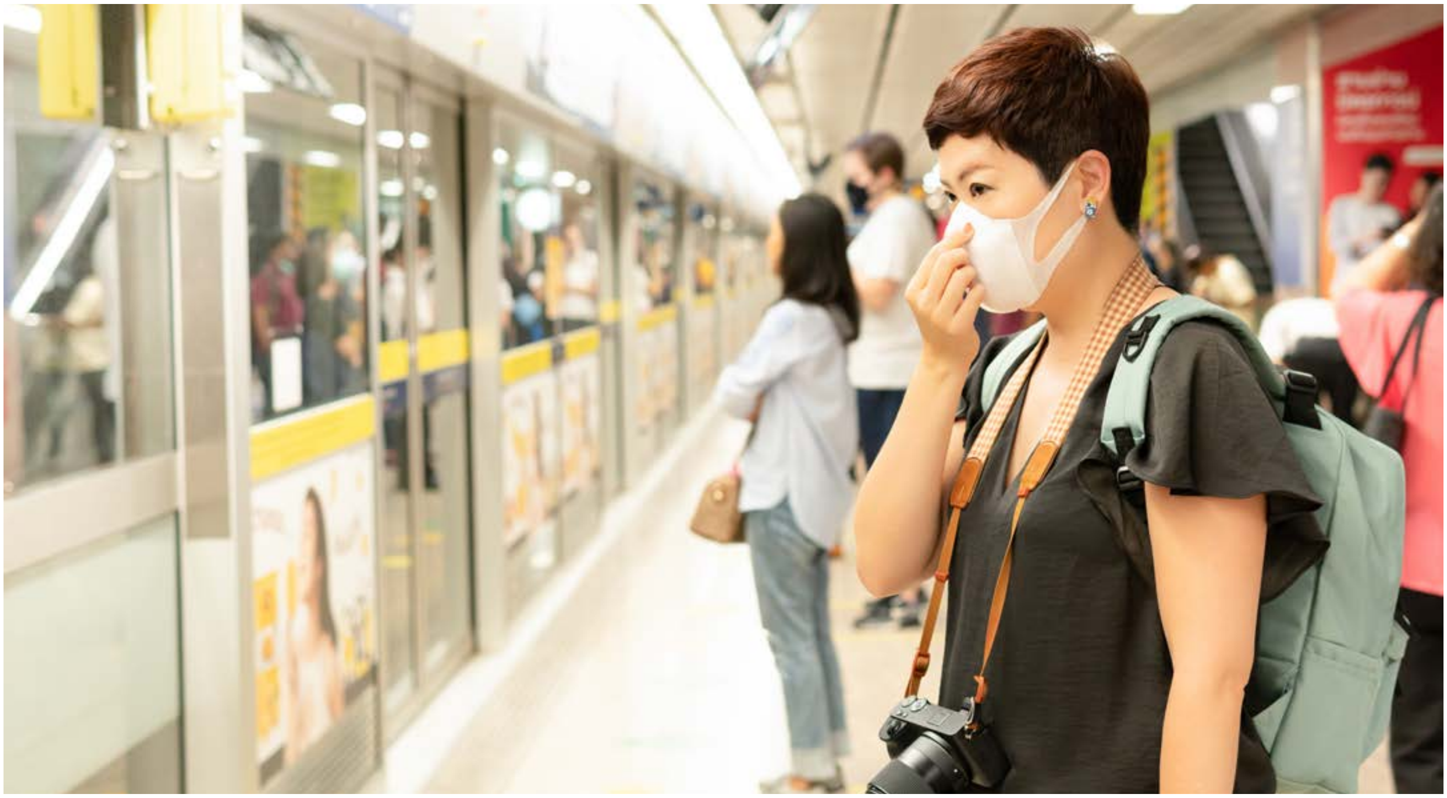
Investing Insights

February 28, 2020

Markets across the globe continue to digest the economic impact of the coronavirus ("COVID-19") epidemic. As of yesterday, global markets were down 12% from their recent peaks in the United States and off roughly 9% to 11% in Japan and Europe. The selloff underway is truly global in nature, as the impact of the commercial disruption appears to be growing at the same time the epidemic threatens to evolve into a pandemic. Separating signal from noise in the headlines is challenging, given the sensational nature of the event.

Epidemic Update

Confirmed cases globally stand at 82,294. Confirmed deaths from the virus is 2,762. The mortality rate which had been fairly stable at roughly 2.5% is now 3.4%. We expect the rate to revert to the earlier level as more cases develop in countries with better health systems. China remains ground zero for the outbreak, as 96.4% of confirmed cases and 98.4% of confirmed deaths are located there. Notably, most of the new cases are occurring outside China as efforts there to arrest the spread of the virus take hold.[1]



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www.FidTrustCo.com

or contact:

Rick Tyson
tyson@fiduciary-trust.com
617-292-6799

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The virus has been renamed "SARS-COV-2," and the illness it creates is called "coronavirus disease 2019" or "COVID-19." The virus is a beta coronavirus, which is the same type of virus that caused SARS and MERS. These viruses tend to originate in bats, which is the likely source of the outbreak. The species jump to humans appears to have occurred in a seafood and live animal market ("wet market") in Wuhan, China.[2]

If the numbers are to be believed, we are encouraged by the drop in new reported cases in China, which suggests a turning point where most of the cases are located. Nonetheless, investors should expect new cases to rise outside China as the epidemic continues its course of transmission.

The Economic Impact

Recent estimates from the International Monetary Fund call for the epidemic to cause a mild disruption to global growth. Current estimates forecast a reduction in 2020 global growth of roughly 0.1%, from 3.3% to 3.2%. Most of this drop is the result of a 0.4% drop in Chinese growth from 6.0% to 5.6%.

This assessment strikes us as too optimistic given the recent reports we are receiving about Chinese coal consumption, electricity output, passenger traffic, car sales, and real estate activity. This pattern of activity suggests a drop in GDP of more than 1% during the first quarter, lowering the expectations for Chinese growth for the year to be closer 5% or less.[3]

How much of the commercial slowdown bleeds into the developed world remains unknown since the spread of the virus in Europe and the United States is still in a relatively early stage. Primary care infrastructure and public health organizations, such as the Centers for Disease Control, are the principal bulwarks against the spread of epidemics in the developed world. These institutions are notably absent or underdeveloped in the emerging world. Given better infrastructure and the aggressive and open communication that is part of developed-world society, we hope the spread of COVID-19 will be more limited in both numbers and mortality in Europe, the Unites States, and Japan.

Based on what is known now, the economic impact of COVID-19 should be compressed into the first quarter, and possibly the second. The effects on businesses will likely be the same as important commercial activity is delayed and not destroyed; for example, delaying car purchases until consumers can travel to shop for their car.

The Markets

Market ructions caused by COVID-19 are not surprising. Any event that threatens commercial activity and therefore corporate earnings will result in market volatility as a consensus forms on the duration and impact of the event. This process takes time.

It is instructive to note that pricing in the U.S. equities market, prior to the outbreak of COVID-19, was exceptional in its optimism: no potential for disruption to the commercial landscape, and no potential for a geopolitical event or trade conflict. Examining market discount rates reveals evidence of this optimism/complacency. With American companies, the implied discount rate of 3.4% was at levels last

Author

Hans F. Olsen, CFA
Chief Investment Officer

seen in mid-2001.[4] In short, discount rates account for uncertainty. Low discount rates suggest low investor uncertainty about future events that could affect earnings, whereas high discount rates imply higher uncertainty about future business conditions. When conditions reflect perfection and perfection fails to materialize, a reset has to occur. This is what is unfolding now.

Portfolio Positioning

We have not recommended changes to portfolios due to the COVID-19 outbreak and the ensuing market drop. Our recommended portfolio accounts for the fact that the future is fraught with uncertainty and prices reflect optimistic outcomes with significant risks to those outcomes.

A challenging first half of the year for global growth is most certainly in the cards. However, if the epidemic exhibits signs of peaking in the next several weeks, a recovery in the third and fourth quarters would be possible. All of this is dependent on containment strategies in countries where the virus is present. The public health apparatus appears to be gearing up for a robust response. We will continue to monitor actively these developments across all our client portfolios—and where prudent, we are using the indiscriminate selling of global markets as a chance to identify and add attractive long-term investments.

We will provide updates as greater clarity emerges, but please reach out to your Investment Officer for more details or perspectives if desired.

[1] Coronavirus disease 2019 (COVID-19) Situation Report-38, World Health Organization 27 February 2020

[2] Coronavirus disease 2019 (COVID-19) Situation Summary, 25 February 2020, Centers for Disease Control and Prevention

[3] China Economics Update, Capital Economics, 26 February 2020

[4] Data from Holt, Credit Suisse February 2020

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