| 2/21/2020 | | Wk | Wk | | YTD | 12 Mos |
|---|---|---|---|---|---|---|
| | | Net | % | Div | % | % |
| **STOCKS** | Close | Change | Change | Yield | Change | Change |
| DJIA | 28,992.41 | -405.67 | -1.38 | 2.21 | 1.59 | 11.71 |
| S&P 500 | 3,337.75 | -42.41 | -1.25 | 1.81 | 3.31 | 19.86 |
| NASDAQ | 9,576.59 | -154.59 | -1.59 | 0.91 | 6.73 | 27.87 |
| S&P MidCap 400 | 2,085.73 | -10.88 | -0.52 | 1.71 | 1.10 | 8.34 |

| **TREASURIES** | Yield | **FOREX** | Price | Wk %Change |
|---|---|---|---|---|
| 2-Year | 1.35 | Euro/Dollar | 1.09 | 0.06 |
| 5-Year | 1.32 | Dollar/Yen | 111.70 | 1.77 |
| 10-Year | 1.47 | GBP/Dollar | 1.30 | -0.43 |
| 30-Year | 1.91 | Dollar/Cad | 1.32 | -0.25 |

Source: Bloomberg/FactSet

### What Caught Our Eye This Week

Last week's NFIB Small Business Optimism Index and other recent economic data have remained mostly positive, but in addition to a decline in today's Markit U.S. PMI figures, investor confidence weakened throughout the week. After several weeks of believing that the coronavirus (CIV19) would only result in a temporary negative adjustment to global economic growth, the market's consensus has slowly begun to acknowledge the potential for an elongated impact caused by the illness. This was seen in adjusted outlooks across a variety of businesses and ranged from an energy company's comments about eroding Chinese demand for natural gas to a major shipping line reducing its 2020 earnings expectations by 5%. Furthermore, one of the world's leading smartphone and electronics manufacturers reduced the profit outlook which they had just recently provided to Wall Street. In a globally interconnected economy that has utilized just in-time inventory to optimize production, any quarantine in China may cause significant disruption to the global supply chain. At a time when many insurance companies now exclude pandemics from their business-disruption coverage after the outbreak of severe acute respiratory syndrome (SARS) in 2002-2003, such delays may cause a hit to corporate profits.

### Economy

Economic data released this week portrayed a mixed picture of the U.S. economy. On Tuesday, January housing starts easily beat expectations coming in at a 1.567 million annual rate which is a 3.6% decline month-over-month and a 21.4% increase year-over-year. Furthermore, building permits jumped 9.2% in January which beat expectations and hit its highest level since 2007. On the inflation front, the Producer Price Index (PPI) rose 0.5% which was well above consensus estimates of +0.1%. Taking out the volatile food and energy categories, "core" PPI also rose 0.5% beating estimates of +0.2%. In other news, the Conference Board Leading Economic Index increased 0.8% in January to 112.1 beating expectations for an increase of 0.4%. According to the news release, the strong pickup "was driven by a sharp drop in initial unemployment insurance claims, increasing housing permits, consumers' outlook on the economy and financial indicators." Finally, on Friday, Markit U.S. PMI data was released. Markit Services PMI came in at 49.4 which was well below estimates of 53.4 and is the first decline in business activity in four years, according to the news release. Markit Manufacturing PMI came in at 50.8 which was also below estimates of 51.5 partially driven by slower expansions in production and new orders.

### Fixed Income/Credit Market

On Friday, the impact of the coronavirus on the U.S. economy became more evident when the Markit U.S. Composite PMI (purchasing managers' index) printed at its lowest level since October 2013. The index gauges composite output at factories and for service providers. A low reading is indicative of potential disruptions to global supply chains. The risk-off mood has sent investors flocking to haven assets, further increasing downward pressure on U.S. Treasury yields. During intraday trading, the 30-year U.S. Treasury dipped to a record low of 1.885% and closed Friday at approximately 1.92%. The 30-year tenor has decreased 47.5 basis points (bps) year-to-date. Furthermore, the yield curve is once again inverted from the 1-month T-bill out to the 5-year Note. The FOMC's preferred measure of yield curve steepness is the spread between the 3-month T-bill and 10-year Note which is currently trading at -8.2 bps.

### Equities

Investors expressed a risk-off sentiment towards equities for the shortened week, as markets posted declines for three out of its four trading days. A combination of the poor Markit U.S. PMI report and general apprehension about the coronavirus appears to be the source of the weakness as opposed to specific market-moving events. On Friday, South Korea reported its first coronavirus related death and reports surfaced of rising cases in Beijing. Iran reported two deaths as well. This information, in conjunction with Apple announcing on Monday that it does not expect to meet its Q2 fiscal revenue guidance of $63B-$67B due to the outbreak, has made investors nervous that the virus' potential business impact was initially underestimated. Concerns are particularly focused on supply chains, manufacturing output, demand, and future earnings. Strong gains in haven assets such as gold and government bonds year-to-date seem to reinforce this uneasiness. For the week, real estate was up 5 bps while all other sectors declined.

### Our View

One of the main questions vexing markets, is the degree to which the coronavirus will weigh on growth in the world's second largest economy. With a fraction of the Chinese economy functioning at this point, certain businesses are finding it increasingly difficult to meet their financial obligations. Back in 2016, President Xi Jinping embarked on a deleveraging campaign that led to a crackdown on shadow banking. Since then, the credit cycle has accelerated and defaults have increased dramatically. Moreover, both investment grade and high yield borrowers have seen credit spreads over government debt escalate to the highest figures since November of 2019. Even though the Chinese government has responded with easier liquidity policies, the funding is not finding its way to smaller private companies, which accounted for more than 80% of the defaults in 2019. With domestic market bond defaults totaling a record 137.6 billion yuan ($19.7 billion) last year, the impacts of the coronavirus will only exacerbate the credit cycle. But, based on 5-year Chinese sovereign credit default swaps, which are trading at 35 basis points (bps) and is well below the 17-year average of 70 bps, the market is confident that the central government has the financial means to absorb the economic impacts from this epidemic. An additional headwind to growth facing China pertains to the country's aging demographic profile. Back in 1979, China enacted the one-child policy due to food and housing shortages the nation was facing at the time. In 2016, however, China revised the policy to allow for up to two children, but it has not helped increase birthrates. Furthermore, there were only 14.6 million births in China in 2019, which was the lowest figure since 1961. It is projected that by the year 2030, China's population will peak at 1.45 billion people and in 2040 24% of the population will be 65 or older. There is no question that China is facing a demographic headwind and even though it has the capacity to handle the issue now, it could unfortunately become progressively more difficult.

| COMING UP NEXT WEEK | | Est. |
|---|---|---|
| 02/25 Consumer Confidence | (Feb) | 132.5 |
| 02/27 GDP SAAR Q/Q (Second Preliminary) | (Q4) | 2.1% |
| 02/27 Pending Home Sales M/M | (Jan) | 2.2% |
| 02/28 Personal Consumption Expend SA M/M | (Jan) | 0.30% |
| 02/28 Michigan Sentiment NSA (Final) | (Feb) | 100.9 |


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