COVID-19 and Financial Markets

US equity markets reached an all-time high on February 19th. A mere three weeks later, the Dow Jones Industrial Average and the S&P 500 were in bear market territory, down 28.3% and 26.9%, respectively. The bond market has also seen dramatic volatility, as the yield on the 10-year US Treasury bond has plummeted from 1.6% a month ago to an intra-day low of 0.3% a couple of days ago. Investors are, understandably, rattled by the pace of these declines as well as their magnitude.

Explanations for the rapid drop are not hard to find. On Wednesday, the World Health Organization officially declared COVID-19 a global pandemic, as it has now reached 112 countries. The entire nation of Italy, with a population of 60 million people, is on lockdown, with travel severely restricted and a halt to almost all commercial activity except food stores and pharmacies. Here in the US, the spread of the virus is at an earlier stage. At least 1,323 people in 41 states have tested positive for the disease, and 38 patients have died. Dr. Anthony Fauci, the director of the National Institute of Allergy and Infectious Diseases, has warned that the outbreak will get worse.

The public health risk, itself, is significant and, unfortunately, growing. Because of the community spread that has now occurred, increasingly strong steps are being taken to try to contain and mitigate the effects as well as the spread of the illness. Seattle public schools have been closed. Sporting events have been canceled, as have conventions and meetings. Businesses have canceled non-essential travel. Public health officials are advocating 'social distancing' strategies.

As efforts to combat the spread of COVID-19 ramp up, the knock-on effects on the economy are likely to grow, too. The economic momentum at the start of 2020 has clearly been impeded. It is hard, at this stage, to quantify with any precision the extent of the growth slowdown, but it is clear that the first and second quarters of the year, at a minimum, will exhibit substantially lower levels of economic activity than had previously been anticipated. The potential for the economy to fall into recession has obviously risen.

In turn, corporate profits, which analysts had forecasted to rise 9-10% this year, will surely fall well short. Companies across a wide array of industries—not just travel-related concerns—have either reduced their earnings estimates or withdrawn those estimates entirely in the face of higher uncertainty.

The combination of economic deceleration and an earnings slump is a prescription for lower stock prices. The sharp drop in US and global stock market prices reflects this changed reality. It also reflects much-heightened uncertainty regarding the length and severity of both the public health crisis and the economic fallout from containment efforts.

Markets will recover, but from what level and when are open questions. Much will depend on the robustness of governmental responses in coming days and weeks. The Fed lowered rates 50 basis points in an emergency action, and appears poised to act further to ensure that credit remains available at low cost and market liquidity is preserved. But monetary policy has its limitations in the face of a non-financial exogenous shock; lower rates will not contain the virus, nor will it ease the financial pain of idled workers and a severely hobbled travel and tourism industry. A strong fiscal policy response is required, and markets are nervous about the ability of the executive and legislative branches to work together to deliver that response.

Hopefully, medical science will make progress in both treating and, ultimately, preventing COVID-19, but the timing is uncertain. There is some evidence that the virus does not survive well in warmer weather, which provides some optimism that the threat may be reduced as we progress through spring and into summer.

Meanwhile, markets will rise and fall in response to the ongoing news flow. That said, long term investors would do well not to overreact to market volatility, and are likely to be rewarded by adhering to carefully designed portfolios that reflect their risk tolerance, time horizon, and objectives. Here at Peapack Private Wealth Management, we emphasize investing in the equity and debt of high-quality companies—businesses likely to survive short term crises and prosper beyond them. We believe this is a fundamental principle for portfolios to exhibit resilience through challenging market environments.

Markets have reset, with lowered expectations. But even as near-term concerns are dominating market participants' actions, patient investors are well positioned to take advantage of market opportunities that are likely to arise. Current economic uncertainty may well be reduced in the second half of the year or early in 2021.

Rest assured that we are closely monitoring economic and market fundamentals and continue to balance capital preservation and capital growth objectives. We encourage you to reach out to your Peapack Private advisor if you would like to discuss your individual situation.

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