Growing fears over the spread of Covid-19, or the coronavirus, have driven the U.S. stock market down nearly 13% from its all-time high of February 19. It is the most rapid correction of 10% or more since the 1930s, and the worst weekly decline in the market averages since October 2008. Concern over the economic impact of the virus' spread are reflected in bond yields as well, with the rate on the 10-Year Treasury falling to 1.13% on February 28, the lowest level since at least 1953.

While the rate of the spread of the virus has moderated in China, it is becoming apparent that economic activity will not return to normal as quickly as originally thought. Factories and businesses both in and outside of Hunan province are beginning to re-open, but workers remain fearful of returning to work. Since we are already two-thirds of the way through the first quarter, China's economic downturn is now more likely to last at least into the second quarter or beyond.

Meanwhile, the daily change in the number of reported cases outside of China has surged. Although the actual numbers remain low, this may change as the virus is known to spread undetected for weeks at a time. South Korea, Japan, Singapore, Iran, and Italy have all experienced a jump in new cases, and what was once being called an outbreak is now being called a pandemic. Public health officials have warned that we must prepare for an outbreak in the U.S., as well, and isolated cases have been reported in at least four states in recent days. These cases, however, have not been traced to any exposure the victims had with travelers from affected countries, and are being referred to as a community outbreak. This may, in fact, be a worse scenario from a purely public health perspective.

In last month's Outlook, we presented a more hopeful view of the impact the virus' spread would have on the global economy and the capital markets. That view was based on information being reported at the time. It is now clear that the *feasible* magnitude of the virus' potential to disrupt global economic activity has increased significantly.

There is, first, the direct negative impact on affected economies of measures implemented to contain the virus. Nobody knows how far the virus will spread or how severe it will become, but the five countries already affected, plus China, account for 25% of the world's GDP. It is possible that the governments of newly affected countries will ultimately take draconian measures similar to those instituted in China. But so far, Japan and Italy have experienced only limited shutdowns, suggesting that economic disruption on the scale of China's may not occur.

Second there are the indirect negative effects of these containment measures on trade and global supply chains. China is, by far, the world's largest exporter of intermediate goods, while South Korea and Japan rank fourth and fifth, respectively. Thus far, the estimated global impact has been minimal. Going forward, the U.S. is undoubtedly the key in determining the severity of any likely supply chain disruption. We are the second largest supplier of intermediate goods globally, and while trade is a small percentage of our GDP, the sheer size of our economy means that we are critical suppliers and purchasers of components to and from other countries.

Third, there is the potential of people to self-isolate by avoiding travel and public spaces like stores, cinemas, restaurants, and the like. Apart from the direct negative impact on retail sales and small businesses, the travel industry is responsible for an estimated 319-million jobs, or roughly one in ten people working on the planet. The reluctance of people to travel also affects the rate at which factories and businesses can re-open even after containment measures are lifted. China's manufacturing data in February was much worse than feared because analysts failed to account for the fact that even though travel restrictions were eased and factories were open, people were reluctant to leave their homes.

Fourth, there is the financial market impact. Analysts have relied on their experience with past outbreaks like the SARS virus and swine flu to suggest that the current weakness is likely to be temporary. But nearly $4-trillion of wealth has evaporated in the U.S., alone, and further spread of the virus is likely to fuel rising expectations for a recession globally, if not in the U.S. The 10-Year Treasury rate has fallen to 1.13% and the yield curve has re-inverted. Moody's Analytics has already pegged the odds of a recession this year to be as high as 40%. If the spread of the virus has disrupted economic activity more than anticipated, the spread of fear, largely through the proliferation of social media, has disrupted the capital markets to a greater extent than during past outbreaks.

Finally, there is the likely policy response from the world's central banks. Pressure is growing on the Fed to cut interest rates, but widespread rate cuts are believed to be unlikely given how low current rates are globally. And even if the world's central banks were to act, it may be unrealistic to expect that their actions would be effective. This is not a financial crisis, but a human one that affects how consumers behave on a daily basis. People are unlikely to go out to dinner and a movie just because the Fed cut interest rates.

In view of the growing uncertainty over the spread of the virus and its effects on the global economic outlook, we have moved to reduce risk in our clients' managed portfolios, mainly by significantly reducing our exposure to international and emerging market equities. We have slightly reduced our domestic equity holdings as well by focusing on those companies most exposed to travel, discretionary consumer spending, and supply chain disruptions. As we are taking this action, we realize that volatile markets, such as this one, eventually create long term opportunities.

In the meantime, trying to gauge the market's reaction to possible scenarios going forward is a fool's errand, if for no other reason than that the best and worst cases are unknowable, and the markets will continue to be driven by fear until the spread of this virus crests. But as someone once told me, the markets can remain irrational far longer than you can remain solvent.


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