Principal Global Investors
February 25, 2020

Coronavirus concerns spark market selloff

As public and market fears converge, here's how to steady your investment portfolio

By Seema Shah, chief strategist, Principal Global Investors, and Binay Chandgothia, portfolio manager, Principal Portfolio Strategies

- Markets experienced a desperate shift in risk sentiment, triggered by multiple coronavirus (COVID-19) outbreaks.
- Particularly alarming has been the jump in infections in South Korea and, now, in Italy, where an urgent lockdown of a group of small towns has affected roughly 50,000 people, with police patrols keeping residents in place.
- Public and market fears have converged with countries outside China anxious that they may be approaching the same point as China was at the end of December—the preliminary stages of a devastating epidemic.
- For investors looking to manage volatility, opportunities exist. Volatility doesn't necessarily imply negative market returns by the end of the year.

Stages of coronavirus concerns

Based on past epidemics, there are patterns to anticipate. It helps to understand them when considering how to insulate your portfolio.

Stage 1 Coronavirus largely contained within China, with factories back to 80% capacity by end-March. Limited supply chain impact; V-shaped recovery.

Stage 2 Coronavirus largely contained within China, factories fail to reach 80% capacity before end-April. Significant China supply chain impact, leading to U-shaped recovery, with weakness in Europe and U.S.

And here's what markets seem to fear will happen next, as seen by the recent market selloff:

Stage 3 Coronavirus spreads outside Asia, leading to drastic containment measures. Global supply chains are significantly negatively impacted, leading to global recession.

To date, it seems markets have been complacent about virus risk and are now realising the threat could be larger than initially estimated. This veers to the view that policy response thus far has been insufficient to insulate the market from supply-side concerns. Travel quarantines may have slowed the spread of the virus but haven't eliminated them, particularly with a spread of meaningful proportions into Korea and Italy adding new dimension to the scare.

The worry is that more quarantines may not solve the problem but could further dent economic activity and investment sentiment.

Coronavirus 2020 vs. SARS 2003

When this new strand of coronavirus hit last month, pundits made early comparisons to the SARS outbreak that centered around Hong Kong and China from November 2002 to July 2003.

Recall that Chinese GDP growth dropped two percentage points from first quarter to second of 2003, and Hong Kong contracted for one quarter. When the outbreak faded, activity rebounded, but not before significant supply chain impact across the globe.

While the viruses may have similar organic similarities, the state of the Chinese economy is vastly different than 2003. Then, when China felt supply chain impacts, the country only accounted for 4% of global GDP. Today, its economy is 4x larger, contributing more than 16% to global GDP, with infinitely more complex and intertwined supply chains.

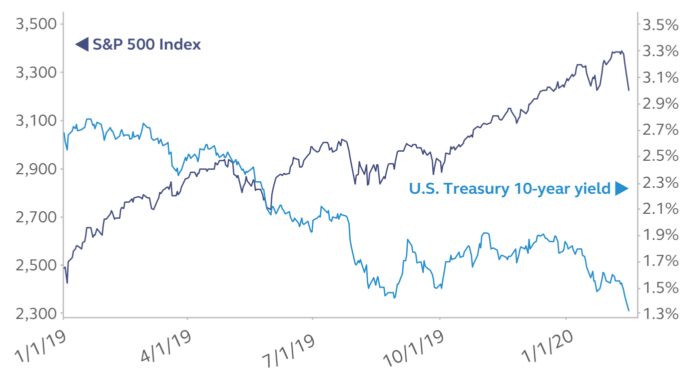
Triggers for recovery

With absolute valuations stretched for several equity and spread asset markets, market vulnerability to negative surprises on the virus is elevated. The key hope rests on policy response—both fiscal and monetary—to dig the world economy out of what's looking to be a disastrous quarter for growth.

With global rates already at all-time lows, accommodative monetary policy will remain a necessary condition for sentiment revival—but must be supplemented with an aggressive fiscal response by central banks. Monetary policy isn't optimized for addressing a shock such as this. Of course, for markets to look beyond coronavirus concerns, they'll need clear signs that the virus has peaked and is being contained.

Risk off is driving both stocks and rates down

S&P 500 TOTAL RETURN INDEX VS. U.S. TREASURY 10-YEAR YIELD, JANUARY 1, 2019 - PRESENT



Source: Bloomberg, FactSet, Principal Global Investors. Data are as of February 24, 2020.

Ways to hedge portfolio risks

One way to hedge your portfolio is to consider investing in what may be safe haven assets, including the U.S. dollar, Treasurys, high quality fixed income, and precious metals. Prices for long duration Treasurys and gold have risen over the past two months, but they could go higher still if investors continue to move into them to protect equity downside. The Japanese yen, traditionally a safe haven, is close to the epicenter of the virus and so may not follow the same trend as the U.S. dollar.

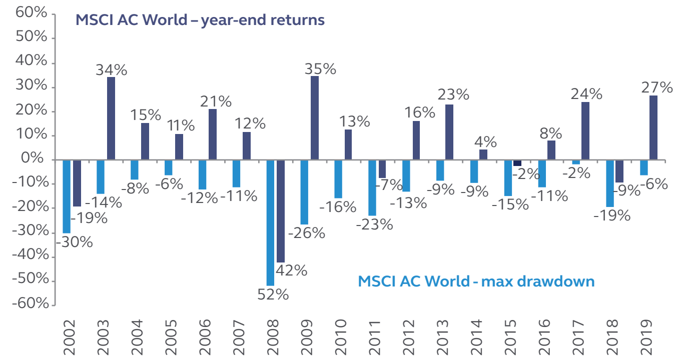
Within equities, defensives such as utilities, real estate, and health care should do well, relative to broad markets. Styles should favor quality and large caps. Regionally, the U.S. should do better than emerging markets and Europe (impacted more by the spreading virus both directly, through developments in Italy, and indirectly, through a large share of exports to China). By contrast, investors may want to minimize their exposure to commodities, luxury goods, and European airlines. On the latter, Asian airlines had been the most sharply impacted, but with the recent development in Italy, Europe may be the next domino to fall.

From a multi-asset perspective, for portfolios carrying significantly higher beta than their strategic benchmarks, higher volatility hedges like long duration Treasurys and gold would likely be more appropriate. For portfolios with manageable levels of risk, hedges in the form of high-quality fixed income assets may also add value. Particularly if the global central banks cut rates or expand their balance sheets. Portfolios with low equity beta and high alpha potential are also likely to do well.

Every year, investors are challenged to differentiate between signal and noise, when it comes to market-moving events. And while the human impact of events can be devastating, history shows volatility doesn't necessarily imply negative market returns by the end of a year. As this outbreak develops further, and hopefully moves toward containment, investors should be cautious not to react emotionally and overstate the impact within their portfolio allocations.

Despite occasionally large intra-year drawdowns, markets have a way of bouncing back

YEAR-END U.S. $ RETURNS VS. MAX DRAWDOWN DURING A CALENDAR YEAR 2002 - 2019



Source: Bloomberg, Principal Global Investors. Data are as of February 24, 2020.

02/2020 | MM11161 | 1100369