LPL RESEARCH
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CORONAVIRUS FEARS INTENSIFY

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Stocks just suffered their worst week since the global financial crisis on coronavirus outbreak fears. Last week's 11.5% drop in the S&P 500 Index brought the index into correction territory. We provide context for the sell-off and discuss potential U.S. and global economic impacts of the outbreak, although this situation remains fluid, very uncertain, and even a bit scary.

CONTEXT ON THE SELL-OFF

Fears surrounding the coronavirus outbreak—or COVID-19—caused significant market volatility this week, wiping out all of the gains from the S&P 500 Index since October 2019. While we want to focus on the economic impacts of the virus in this commentary, we first want to provide some context on the sell-off:

- The 12.8% decline in the S&P 500 since February 19 is the sharpest seven-day correction off an all-time high ever recorded in the history of the S&P 500 going back to 1957, with a correction defined as a 10% or greater decline from record highs based on closing prices.
- With the S&P 500 having broken below the 200-day moving average at around 3,050, we are looking to last year's August lows at around 2,850 as the next potential level of support from a technical analysis perspective.
- The VIX (Chicago Board Options Exchange's Volatility Index) measure of implied volatility hit an eight-year high of 45. Outside of the financial crisis, this measure of market volatility implied by the options markets has only exceeded that level three times in the past 20 years: 2002, 2010, and 2011.
- Based on the intensity of the selling we observed Thursday and Friday, we would suggest that a fair amount of the first phase of a bottoming process has taken place, though establishing a base after significant market shocks like this one has tended to take a bit of time. We're watching for more evidence of capitulation.
- The forward price-to-earnings ratio for the S&P 500 has fallen about 2.5 points during the sell-off, from an above-average 19 to 16.6, right around the long-term average. Given low interest rates and well-contained inflation, we find stocks attractively valued at current levels.

BACKGROUND ON COVID-19

Background information on COVID-19 is important to consider when discussing the potential economic impact:

- So far more than 83,800 cases have been reported, causing 2,867 deaths and spanning about 40 countries. Approximately 95% of the known cases are in China, mostly within the Hubei province. (As of 02/28/20.)
- The mortality rate has been about 3% overall, although that rate may be overestimated given the number of unreported cases and a shortage of test kits. The rate has been higher in China (3.5%) and

lower in Hong Kong (2.3%), Japan (1%), South Korea (1%), and Singapore (zero deaths and 93 cases), according to data compiled by Johns Hopkins. Survival rates among younger people have been very high.

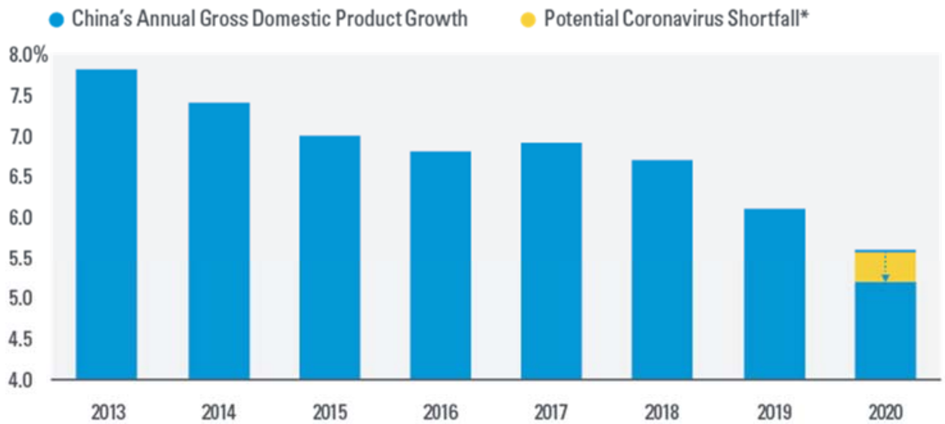
- More than 36,000 people reportedly have recovered from the virus in China, along with 400 people outside of China.
- We don't want to minimize the human loss, but the common seasonal flu takes 23,000–61,000 lives in the United States each year, with a 0.1% to 0.2% mortality rate. Several cases of community transmission in the United States have been reported, which led to some quarantining and increased concerns of a wider outbreak. The quality of the U.S. healthcare system and awareness will greatly increase the odds of domestic containment in our view.
- Significant progress toward a vaccine has been made, and the typical multi-year timetable for approval has been shortened significantly.

ASSESSING ECONOMIC IMPACT

Our approach as always is to focus on economic fundamentals first, but the uncertainty around the scope of this outbreak has made it very difficult to assess potential economic impact. Even as the situation remains fluid and very uncertain, we want to provide some sense of potential U.S. and global economic impact.

China. If containment continues to progress in China, the epicenter of the outbreak, which is our expectation, we could see something near flat Chinese economic growth in the first quarter, rather than the estimated 5–6% GDP growth. We believe this most likely would be followed by a potential return to trend growth by the third quarter. We would estimate that scenario would put 2020 GDP growth in China about one percentage point below the current 5.6% Bloomberg-tracked consensus. The best case scenario for GDP growth in China this year is probably 5% **[FIGURE 1]**. A two-month pause in the Chinese economy would represent about a 1% hit to GDP growth for this year in our view, some of which has been reflected in Bloomberg's consensus forecasts.

1 A 1% HIT TO 2020 CHINESE GDP GROWTH MAY BE BEST CASE SCENARIO



Source: LPL Research, Bloomberg 02/27/20

*Estimates reflect Bloomberg consensus estimates and LPL Research estimate of possible shortfall related to COVID-19 outbreak.

Economic forecasts may not develop as predicted.

United States. The U.S. economy is being impacted by the outbreak from both the demand side—through slower growth in China and Asia—and the supply side—from China's significant role in global supply chains. We estimate that the outbreak may trim 0.25–0.5% from U.S. GDP over the next couple of months due to global supply chain disruption, falling export demand, and decreased tourism. On top of that, lower stock prices may hit consumer confidence and create a negative wealth effect.

If evidence emerges over the next four to six weeks or so that the virus is being successfully contained here at home, the economic impact would likely be at the better end of the range mentioned above (.25%). In that scenario, damage to business and consumer confidence would be limited, setting the stage for a potential second-quarter resumption of domestic economic activity. The U.S. economy was in pretty good shape before the virus began to spread beyond China, and it still has yet to realize much benefit from the recently signed trade deal with China, including lower tariffs and reduced uncertainty.

We believe our 1.75% U.S. GDP growth forecast for 2020 remains achievable given the boost from the U.S.-China trade deal, which has not yet been realized, and a U.S. consumer that remains very well positioned to keep spending. That said, we acknowledge the increased downside risk.

Global. In the short-term, the collective hits to global GDP from China, South Korea, Japan, and Italy—countries where the outbreak's impact has been greatest to date—may comprise 0.2–0.3% of global GDP. Containment measures in the United States and elsewhere may add to the economic downside risk. Our latest global GDP growth forecast of 3.5% from our *Outlook 2020* publication is too high in light of the latest news. We expect to update/reaffirm our economic forecasts once we have more clarity around the COVID-19 impact in the weeks ahead.

DOWNSIDE RISK TO EARNINGS

If U.S. and Chinese economic growth come through as expected, we think S&P 500 earnings per share (EPS) growth for this year could still approach the mid-single-digit range. However, we recognize there is some downside risk to our $175 per share forecast for 2020, which represents about a 7% increase. Successful containment in the United States and steady progress in China could limit the downside risk to that estimate, but frankly it's too early to tell.

WHERE DO WE GO FROM HERE

We believe stocks have fallen to levels we would consider very attractive based on our assessment of economic and market fundamentals. We are evaluating our published economic and market forecasts at this time and expect to provide an update shortly. At this point, our best advice would be to consider staying the course, and maybe think about some rebalancing "around the edges" to add some equity exposure on weakness where appropriate. Uncertainty remains very high, but based on what we know now, we think this sell-off appears overdone relative to most reasonable scenarios.

Last but not least, our hearts are with those affected by this outbreak. Like all of you, we will continue to follow the news closely in the days ahead, and we will keep you updated on any major developments.

WEEKLY MARKET PERFORMANCE REPORT

Please see our new *Weekly Market Performance* report with insights on major asset classes.

WMC

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