Market Note

TIMELY DISCUSSION OF MARKET-MOVING TOPICS
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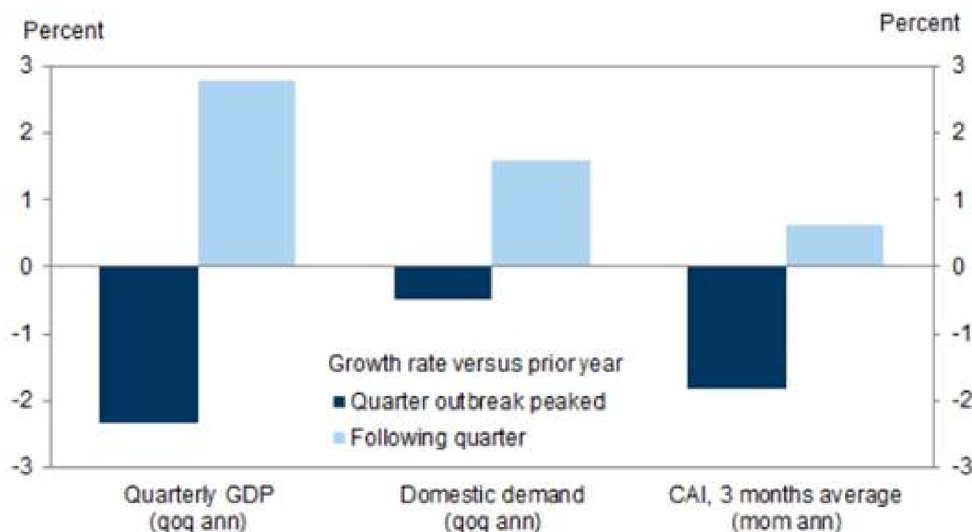
BOTTOM LINE: Investor concerns over the new coronavirus strain spiked on Monday after reports of a surge of infections in Italy. Past viral outbreaks have typically resulted in short, sharp shocks to economic output and a short-lived flight to quality in capital markets. The current market dynamic suggests that investors are reacting to more than concerns about the virus – recovery and new gains in the equity market will require confidence in valuation in addition to the expectation that the virus will be contained. Investors may find the best balance with high quality, dividend-oriented equity.

MAIN POINTS

1. **Investor concerns over the new coronavirus strain ("2019 n-CoV" or "COVID-19") spiked on Monday after reports of a surge of infections in Italy.** The continued spread is particularly disappointing after reports that the number of new cases in China had seemingly peaked. So far, the economic impact of the virus has been driven by measures taken to prevent the spread of the virus rather than the direct impact on health. Based on current information, the direct health impact of COVID-19 will be a fraction of the annual impact of seasonal influenza – the World Health Organization estimates 3 to 5 million cases of severe illness and 300,000 to 650,000 respiratory deaths annually.

2. **Past viral outbreaks have typically resulted in short, sharp shocks to economic output.** The typical slowdown phase lasted 1-3 months and cut one quarter's annualized GDP growth by several percentage points in the most affected countries, though outcomes are highly sensitive to the duration of the outbreak and the severity of measures taken to control it. Activity has typically recovered to trend 2-3 quarters after the onset.

Growth typically rebounded in the quarter after outbreaks in historical episodes



CAI refers to Current Activity Indicator, a measure of economic activity. Shows median of SARS (China, HK, Canada), MERS (S. Korea), H1N1 (US, Mexico), H7N9 (China). As of 1/29/20. Source: Haver Analytics, GSGIR.

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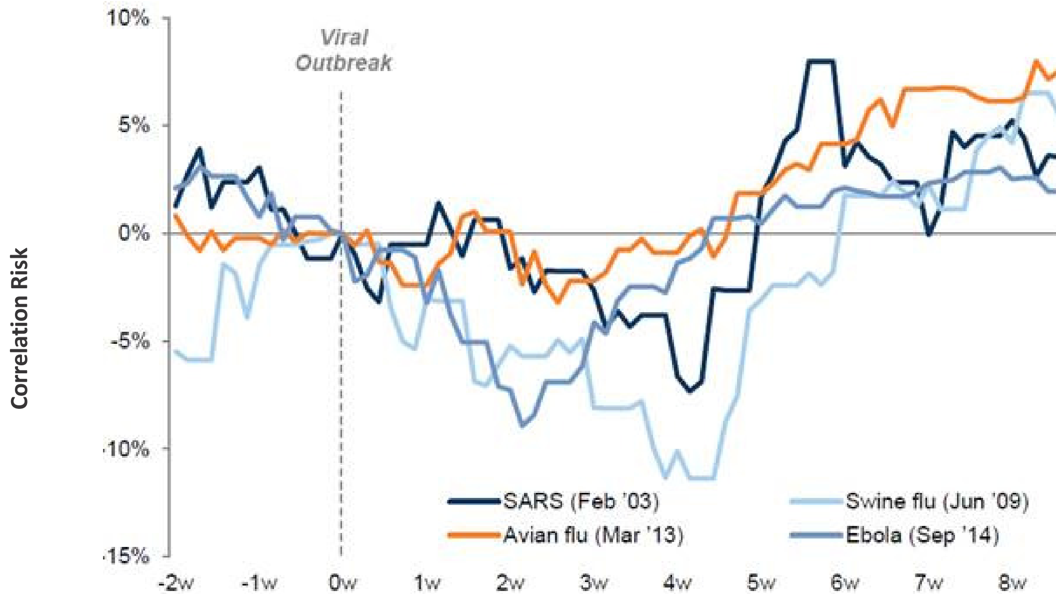
3. Historically, the panic generated by epidemics has driven a short-lived flight to quality in capital markets. Around the four previous epidemics, it took on average 4 weeks for the S&P 500 to start recouping losses relative to the US 10y. After the initial hit to equity markets and drop in bond yields, the equity market reaction typically turned positive again when the rate of new infections started to slow. Thereafter, bond yields have tended to stay at lower levels for longer, offering some support to equity valuations – post-trough performance over 3-6m in previous virus outbreak episodes has been +20-30%.

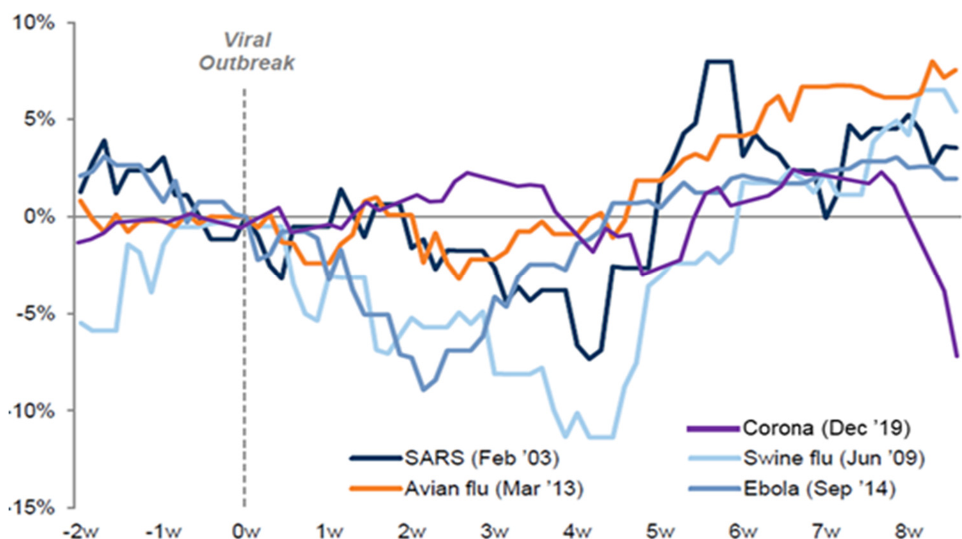
Around previous epidemics, risky assets have traded poorly for roughly 4 weeks



S&P 500 v. US 10y bond during previous viral outbreaks. As of 1/29/20. Source: Datastream, GSGIR.

4. The current market dynamic suggests that investors are reacting to more than concerns about the virus. Prior experiences may have given investors confidence – until this week, the market consensus seemed to be that the economic impact would be short-lived and reversed with a strong rebound in the next few quarters. But though equities continued to rise in January and February, bond yields started to fall at the end of January due to concerns about economic growth generally. The bond market rally and sharp drop in the equity market has created a "risk-off" dynamic that is unusual compared to other episodes.

Flight to safety has been more pronounced this time



S&P 500 v. US 10y bond during previous viral outbreaks. As of 2/25/20. Source: Datastream, GSGIR, Bloomberg, AssetMark.

5. **Recovery and new gains in the equity market will require confidence in valuations in addition to the expectation that the virus will be contained.** Looser financial conditions have been the main driver of equity returns since the very sharp drawdown in equities in 4Q18. On average, over 90% of the total return in global equity markets last year came from higher P/E multiples. For both European and US capital markets, most metrics are at the top end of their long-term ranges. While the S&P 500 has been at high valuations for a long time relative to history (largely reflecting stronger growth than other equity markets and also a function of the high technology composition), valuations in Asia and Europe have increased much more recently. For example, the P/E percentile in Europe has gone from 25% (i.e., cheaper than 75% of the history) at the end of 2018 to 85% now. The rise in valuations relative to history is apparent across financial assets, including debt and credit markets.

Valuations across US markets are high relative to history

Correlation Risk

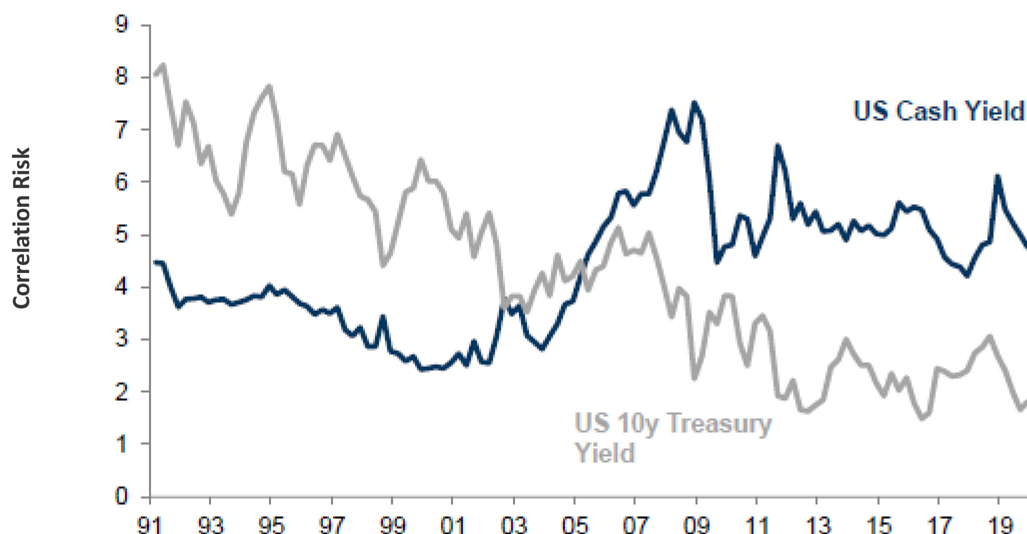
	Metrics	Current Level	Historical Percentile	Median
Equity (SPX)	EV / Sales	2.7	100%	91%
	EV / EBITDA	13.7	97%	
	Price / Book	3.8	91%	
	NTM P/E	19.2	91%	
	NTM Free cash flow yield	3.9	58%	
	Cyclically Adjusted P/E	28.4	90%	
	ERP	5.1	21%	
Rates	Nominal 10-year Treasury	1.6%	99%	90%
	Real 10-year Treasury	-0.1%	82%	
Credit	High Yield YTM	5.9%	100%	
	Investment Grade YTM	2.7%	100%	
	High Yield spread	357bp	80%	
	Investment Grade spread	102bp	76%	

US data goes back to 1976, apart from free cash flow yield (FCF, 1990), credit market data (1997), government bond yields (1921) and equity risk premium (ERP, 2001). S&P 500 v. US 10y bond during previous viral outbreaks. As of 2/19/20. Source: Datastream, FactSet, GSGIR.

6. **While equity market risk due to valuation may be elevated, performance over the past six months reflects the resilience of the current economic expansion.** The global economy is expected to continue to expand despite the US having already experienced the longest economic expansion in 150 years. The typical triggers of recession, rising interest rates and deteriorating private sector imbalances, for example, are not evident. The strength of household balance sheets and improved private sector debt positions provides a strong cushion to shocks, such as the coronavirus. The personal saving rate in the US, for example, remains elevated at 7.7%, well above the rate one would expect with the household wealth-to-income ratio near historic highs and unemployment risk near historic lows. Without recession, profits and dividends are likely to grow over time, albeit more modestly.

7. Investors may find the best balance with high quality, dividend-oriented equity. The spread between equity cash yields and risk free rates is elevated, suggesting that equities, despite high valuation multiples, remain attractive compared with other asset classes. Valuations in global bond markets (where approximately $14trn of government debt has a negative yield) is even more stretched, leaving the equity risk premium (ERP) as the only major metric which is moderately valued compared with history. High quality, dividend-oriented equity portfolios may offer an appealing balance of current income, lower volatility than broad equity markets and potential upside due to their lower valuation relative to growth companies.

Equities remain attractively valued relative to bonds



US (equity) cash yield includes dividend yield and buyback yield. As of 2/19/20. Source: Compustat, Datastream, Worldscope, GSGIR.

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