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What happens when the coronavirus hits the economy hard?

Equity markets around the world are falling as investors react to the increased economic risk posed by the spread of the Coronavirus, or COVID-19.

While investors were largely unresponsive to the news of the coronavirus in early-to-mid February, a surprising escalation of the number of infections in Italy appears to have been the catalyst for turning investor attention toward the risks.

We can't predict risk, nor what may spur a market correction. It's our job to manage risk. The markets are now faced with the economic disruption fueled by the emergence of the coronavirus.

United States
While the U.S. economy may be the least vulnerable to the potential economic fallout of the virus, this doesn't mean the economy won't suffer its ill effects. U.S. fourth quarter GDP growth was reported at an annualized rate of 2.1%, which is irrelevant to the situation as of February 27. Manufacturing activity that showed a modest rebound in January is expected to contract in February.

Energy & Oil
Considering the uncertainties surrounding the coronavirus's impact on the economy, there is less doubt on its impact on energy prices. The International Energy Agency (IEA) has slashed its Q1-2020 global demand forecast by 1.3 million barrels per day–and if correct, it would be the first year-over-year drop in demand in more than a decade. China accounts for more than three quarters of growth in global oil demand according to the IEA.

Europe
Where some European countries have closer economic ties to China and noting the increasing number of coronavirus cases in countries such as Italy, the economic consequences may be like what Asia will experience. Heading into 2020, European Industrial Production was slowing in reaction to an already slower Chinese economy. In fact, since global exports were still straining from the U.S./China trade disputes in December, the current supply chain disruptions will only delay the recovery. Therefore, any rebound in Europe will depend on a rebound in China.

Market corrections
Corrections, a drop in equity markets of greater than 10%, are fairly common. Bear markets, a drop in equities of greater than 20%, are usually more associated with recessions. Not to suggest the current market volatility is attributed to a pending recession. It's unlikely there's enough evidence of such an economic consequence at this time. And therefore, it's not suggested the current volatility will materialize into a definitive bear market. At the same time, the "buy the dip" mentality that has permeated the market over the past number of years warrants some caution. The current economic and market conditions demand careful consideration.

The volatility in this case could be considered a combination of sentiment and fundamental drivers. The coronavirus is both catalyst and cause to the market volatility and unlikely to subside in the near-term. To buy the dip and increase risk assets in a portfolio may not be wise until there's more confidence in the future economic and earnings environment.

In hindsight, a balanced posture ahead of the current volatility was a prudent approach to asset allocation and remains so in light of the economic environment, and until we see signs of improvement.

As always, if you have any questions about the markets or your investments, I'm here to talk.

Regards,

Manulife Capital Markets