

## ECONOMIC OUTLOOK

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### *Summary*

Since our last Economic Outlook, the novel coronavirus has spread beyond the borders of mainland China. It now has a solid foothold in South Korea, Italy and Iran, with a smaller representation in many other countries. This development has triggered a significant volatility shock throughout all asset classes of global markets, starting in mid-February. In fact, the only thing that seems to be spreading at a faster rate than the virus is the overall fear and underlying economic uncertainty it's causing.

Rather than fixating on abstract economic hypotheticals, let's redirect the focus to things that are a bit more tangible. Locally in the Midwest, manufacturing activity had its first meaningful increase in more than a year throughout the Federal Reserve Bank of Kansas City's Tenth District. On the national front, the final "pre-coronavirus" jobs report came in with exceptionally strong headline numbers, adding nearly 100,000 more jobs than expected in February (273,000 total), while also revising January's job growth higher by nearly 50,000 jobs (also 273,000 total). Personal Income rose by 0.6%, which represented the highest levels in a year and beat estimates. The ISM Non-Manufacturing Index also came in significantly higher than expectations (57.3 vs 54.8 – where a reading below 50 is negative and above 50 is positive), and consumer confidence remains elevated.

While there are many genuine uncertainties regarding the ultimate economic impact of the Coronavirus, it's clear that the consumer remains well-positioned and the domestic economy has

a solid foundation. Although the Federal Reserve Open Market Committee surprised markets with a 50 basis point cut of the Fed Funds rate in early March, this was not due to an already weak economy that is deteriorating further. Instead, it was aimed at sheltering the economy against some of the potential uncertainties and inevitable slowdowns on the horizon. As we move forward it would serve us well to remember this journey started with a solid economic foundation.

### *Positives*

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Unemployment rate decreased to 3.5%

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Pending home sales beat expectations by 4.5% (2.1% vs 6.7%)

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A 0.5% reduction of the Fed Funds rate

### *Negatives*

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ISM manufacturing numbers missed estimates and are barely positive (50.1)

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Factory orders declined more than expectations (-0.5% vs -0.1%)

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Markit U.S. Services PMI fell into contraction territory (49.4)

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## EQUITY OUTLOOK

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### *Summary*

The first couple of weeks of February saw global equity markets continue the momentum we witnessed at the close of 2019 as it appeared the impact of the coronavirus would be largely contained inside China. That sentiment quickly shifted in the latter half of the month as evidence surfaced the virus had spread in other parts of the world with significant outbreaks in Iran, Italy, and South Korea. In the final week of February, the S&P 500 suffered the largest weekly pullback since the 2008 financial crisis and in total the index declined 8.2% for the month.

International markets bore the same fate. The foreign index of developed economies MSCI EAFE Index fell 9.0% and the MSCI Emerging Markets Index lost 5.3%. Large cap growth stocks, while weak, held up better than value stocks as the Russell 1000 Growth Index dipped 6.8% compared to the Russell 1000 Value which lost 9.7%.

All economic sectors retreated during the month of February. Significant moves lower in interest rates and crude oil prices pressured financials (-11.2%) and energy (-14.6%) as the worst performing sectors. Real estate, aided by declining rates, tied communication services as the best performing sectors for the month but were still off 6.3%.

It's nearly impossible to quantify the absolute magnitude of the impact from the coronavirus. Many in the scientific community agree the outcome, from a pure public health standpoint, will likely be muted and not much worse than a bad flu season. Today's media, though, has a tendency to play on readers' fears and focus on negative news. Global reaction to the virus has already resulted in supply chain disruption and has caused central banks to take notice. In the opening days of March, the Group of

Seven (G7) promised to use "all appropriate policy tools" and the Federal Reserve Open Market Committee held a rare surprise meeting to announce a half-point cut to the Fed Funds rate in an effort to mute the economic impact of the coronavirus.

Given the virus uncertainty, domestic political climate and trade discussion, which have seemingly been put on the back burner, we are likely to see continued volatility in risk markets throughout the balance of the year. It's important to note that broad economic conditions have been and remain solid. Plus, lower rates that have fueled the bull market over the last decade are likely to continue. There will be periods of volatility, no doubt, but we still feel significant pull backs represent unique opportunities for long-term investors.

### *Positives*

Resilient U.S. consumer and labor markets

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TINA – There Is No Alternative (to equities)

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Accommodative Federal Reserve

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### *Negatives*

Coronavirus impact and ripple effects

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Slowing global growth

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### *Unknowns*

Signs of trade progress but a very long way to go

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## FIXED INCOME OUTLOOK

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### *Summary*

In reacting to the fast spreading coronavirus, investors sold equity securities and flocked to the safety of the U.S. Treasury market. The demand pushed prices higher and yields down across the entire maturity spectrum with longer-dated bonds breaching historic lows. The 2-year note ended February a massive 40 basis points (bps) lower at 0.91%, a level last seen in November of 2016 when the Fed's overnight rate was targeted at a 0.25% to 0.50% range. The 10-year declined by 36 bps to end at 1.15% and the 30-year bond dropped 32 bps to a record low of 1.68%. Intermediate Treasury notes delivered a return of 1.66% for the month and 3.11% for the first two months of the year. Credit spreads increased by about 17 bps for the month and 27 bps for the first two months of this year. Investment-grade corporate bond returns trailed those of Treasuries at 0.99% for February and 2.46% for the two-month period.

These moves all occurred before the Federal Reserve came in with an emergency intra-meeting rate cut of 50 bps on Tuesday, March 3. Instead of signaling that the Fed will be there to support the economy and the efficient access to credit, the markets took the cut as a sign that the Fed knows more than the markets about the virus and that the outlook is troubling. The stock market dropped further and Treasury note yields entered a freefall. Since the cut, the 2-year yield has traded below 0.50% with the 10-year below 0.70%.

Some investors and market strategists have questioned the logic of the Fed's action, either the timing or the size of the cut, and believe it was ill-advised and a policy error. We do not find that to be the case. The Fed did exactly as it said it would months ago when asked if there would be more rate cuts ahead. They stated that they would change policy if there was a material change in their assessment of the outlook for the economy. Coronavirus is that material change. We do not

believe that the Fed has more information than the rest of the market about the virus, but rather they are simply analyzing the impact that the virus has already had on the world's economies and making policy more accommodative to assist in offsetting some of that impact.

Rate cuts and lower interest rates will not stop the spread of the virus, make people want to get on planes, go into restaurants, or rebook all of the conventions that have been cancelled. But with inflation continuing to miss their target, there is no reason for the Fed to stop here. We are looking for the Fed to make further cuts in the overnight rate in an effort to protect the longest economic expansion in history from coming to an end.

### *Positives*

Federal Reserve's rate policy can only go lower in the next few years

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Economies around the world are under pressure as virus spreads

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### *Negatives*

Longer maturity U.S. Treasury yields are at historic lows

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Investors could sell bonds and buy stocks at discounted prices

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### *Unknowns*

Ability to contain the spread of the coronavirus

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Markets reaction as Democratic candidate emerges

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