



MORNING BRIEFING

February 25, 2020

Anatomy of a Virus

Check out the accompanying [chart collection](#) and [podcast](#).

(1) Panic Attack #66 hit investors hard yesterday. (2) A viral panic attack. (3) In the spring, there should be healthier weather. (4) Counting on the flu model. (5) Travel and tourism industries are sick. (6) P/E-led correction following P/E-led meltup. (7) The man from WHO isn't ready to call it a pandemic despite spread to Iran, Italy, and Korea. (8) Getting harder to breathe for millions of small businesses. (9) Fed may need to deliver a couple more rate cuts to keep US economy in a good place. (10) Wuhan Institute of Virology may be China's Chernobyl.

Virology 101: Infecting Stocks. The S&P 500 stock price index peaked at a record high of 3386.15 last week on 2/19. It's been falling every day since then, closing at 3225.90 yesterday, down 4.7% from the latest record high. The COVID-19 outbreak hit the headlines a month ago on Friday 1/24 ([Fig. 1](#)). The S&P 500 is down 3.0% since 1/23, the day before the headlines ([Fig. 2](#)). Panic Attack #66 clearly isn't over. It has the potential to turn into one of the more severe corrections of the current bull market. It could turn into a bear market if it causes a recession in the US. Joe and I still think the selloff is a panic attack that's more likely to be followed by a relief rally than the beginning of a bear market.

We aren't virologists, but we continue to expect that the virus outbreak will be contained and abate as the weather improves during the spring. So far, it has been much less severe and deadly than the seasonal flu. Governments have responded to COVID-19 with significant quarantines, unlike their laid-back responses to the seasonal flu. That increases the chances that the outbreak will be contained. But the quarantines are disrupting global supply chains and increasing the chances of a global recession, at least in the manufacturing sector. In addition, the global travel and tourism industries are getting hit hard as flights and public events are being cancelled. Let's review the latest developments:

(1) *P/E-led correction.* The S&P 500 has been on a P/E-led meltup from 12/26/18, when it bottomed at 13.5, through last Wednesday, when it hit a high of 19.0 ([Fig. 3](#)). That's a 41% increase. Over that same period, forward earnings rose just 2.4% ([Fig. 4](#)). The forward P/E fell

to 18.0 yesterday.

Through the 2/13 week, there were no signs yet that the global health crisis has been depressing S&P 500 forward revenues, forward earnings, or forward profit margins ([Fig. 5](#)). However, industry analysts have been cutting their Q1 and Q2 estimates for S&P 500 operating earnings per share at a faster pace over the past three weeks through the 2/20 week ([Fig. 6](#) and [Fig. 7](#)). They are currently projecting that earnings will be up just 0.7% y/y during Q1 and 4.8% during Q2.

(2) *From epidemic to pandemic*. In our 1/27 [Morning Briefing](#), titled “Going Viral,” we wrote: “What’s the difference between an epidemic and a pandemic? The former occurs when a disease either affects more people than usual within a locality or spreads beyond its usual locality. A pandemic is an epidemic of worldwide proportions. The recent coronavirus outbreak has the potential to turn into a pandemic since it has already spread beyond China’s borders.”

Monday’s steep decline in stock prices around the world reflected mounting fear that China’s epidemic is turning into a full-blown global pandemic as the number of cases rose in Iran, Italy, and South Korea over the weekend.

On Monday, the price of copper moved lower, while the price of gold rose to a seven-year high of \$1,671.65 per ounce. The latter is highly inversely correlated with the 10-year US Treasury TIPs yield ([Fig. 8](#)). The ratio of the price of copper to the price of gold is highly correlated with the 10-year US Treasury bond yield, which fell to 1.38% yesterday, the lowest on record ([Fig. 9](#)). The yield curve spread between the federal funds rate and the 10-year US Treasury bond yield turned negative again, falling to -21 bps yesterday from a recent high of 38 bps ([Fig. 10](#)).

Mike Ryan, executive director of the World Health Organization’s Health Emergencies Programme, said yesterday that it’s too early to declare the novel coronavirus a pandemic. “Look what’s happened in China, we’ve seen a significant drop in cases, huge pressure placed on the virus and a sequential decrease in the number of cases, that goes against the logic of pandemic. Yet we see in contrast of that, an acceleration of cases in places like Korea, and therefore we are still in the balance.” He added: “We are in the phase of preparedness for a potential pandemic.”

South Korea counts six dead from the coronavirus and more than 600 infected. Italy has seen two deaths and 100 confirmed cases of the virus. Lombardy and Veneto are under strict quarantine; no one can enter or leave for the next two weeks without special permission. Beyond the quarantined zones, many businesses, schools, sports games, and events in Italy, including the Venice Carnival, have been suspended or cancelled. In the Middle East, Iran's borders are closed, and flights into the country have stopped.

(3) *The X Factor*. A 2/21 Bloomberg [article](#), "Coronavirus May Be 'Disease X' Health Experts Warned About," reported: "The World Health Organization cautioned years ago that a mysterious 'disease X' could spark an international contagion. The new coronavirus illness, with its ability to quickly morph from mild to deadly, is emerging as a contender. From recent reports about the stealthy ways the so-called Covid-19 virus spreads and maims, a picture is emerging of an enigmatic pathogen whose effects are mainly mild, but which occasionally—and unpredictably—turns deadly in the second week. In less than three months, it's infected almost 78,000 people, mostly in China, and killed more than 2,300. Emerging hot spots in South Korea, Iran and Italy have stoked further alarm."

Furthermore, "Unlike SARS, its viral cousin, the Covid-19 virus replicates at high concentrations in the nose and throat akin to the common cold, and appears capable of spreading from those who show no, or mild, symptoms. That makes it impossible to control using the fever-checking measures that helped stop SARS 17 years ago."

(4) *Canaries in China's economy*. While US Treasury yields have fallen in the US on fears that the coronavirus could weaken US economic activity, forcing the Fed to cut the federal funds rate, credit quality spreads have remained remarkably low ([Fig. 11](#)). However, this time (unlike during 2008), dodgy credit quality is probably a much bigger problem for China than for the US.

Indeed, China may be the epicenter of the world's next credit crisis. The October 2019 [Global Financial Stability Report](#), produced by the International Monetary Fund, warned: "In China, overall corporate debt is very high, and the size of speculative-grade debt is economically significant. This is mainly because of large firms, including state-owned enterprises. In addition, the debt-at-risk in China is found to be very sensitive to deteriorations in growth and funding conditions (because of a large share of speculative-grade debt) and it surpasses post-

crisis crests in the adverse scenario presented in this chapter. The assessment of the potential systemic impact of corporate vulnerabilities is complicated by the implicit government guarantees and the lack of granular data on corporate sector exposures of different segments of the large, opaque, and interconnected financial system in China.”

Maybe so. However, the current virus health crisis is stressing the finances of millions of small Chinese firms, according to a 2/22 Bloomberg [article](#). It reported: “A survey of small- and medium-sized Chinese companies conducted this month showed that a third of respondents only had enough cash to cover fixed expenses for a month, with another third running out within two months. Only 30% of such firms have managed to resume operations due to a complicated local government approval procedure as well as a lack of employees and financing, a government official said at a press conference on Monday.”

(5) *US still “in a good place?”* Fed officials have been saying for quite some time that the US economy is “in a good place.” They started using that expression during 2018, Jerome Powell’s first year as Fed chair. Yet to keep it in a good place, Powell and his colleagues had to pivot last year from gradually raising the federal funds rate three times to lowering it three times instead. They started out 2020 expecting to leave the federal funds rate unchanged this year. As the virus crisis has spread over the past month, the US 10-year Treasury bond yield, the 2-year Treasury note yield, and the 12-month forward federal funds rate futures all have been signaling that investors expect the Fed to cut the federal funds rate by another 25-50 bps over the rest of this year ([Fig. 12](#) and [Fig. 13](#)).

(6) *Fast-tracking cures.* Drug companies are scrambling to find either a cure or a vaccine for COVID-19. Gilead has been ramping up manufacturing of remdesivir, to meet a surge in demand if the drug proves effective in two clinical trials of 760 Chinese patients and a handful of patients requesting emergency use.

Virology 101: China’s Chernobyl. In the 2/11 [Morning Briefing](#), I suggested that the coronavirus outbreak could be China’s Chernobyl:

“Could the coronavirus outbreak do to China anything like the Chernobyl nuclear catastrophe did to the Soviet Union—arguably setting the stage for its rapid collapse by manifesting the consequences of incompetency and corruption in a national government? ... China’s economy

is in much better shape today than was the Soviet Union's economy before it disintegrated. However, the coronavirus outbreak has the potential to cause a social explosion that could set the stage for the meltdown of the Communist regime."

There has been speculation that the source of the virus wasn't the seafood market in Wuhan but rather the Wuhan Institute of Virology (WIV) located only a couple of miles from the market. The institute has a [website](#) that doesn't mention the coronavirus outbreak!

The 2/22 *NY Post* has an [article](#) titled "Don't buy China's story: The coronavirus may have leaked from a lab." It was written by Steven W. Mosher, the president of the Population Research Institute and the author of "Bully of Asia: Why China's 'Dream' Is the New Threat to World Order." He makes the following thought-provoking and unsettling points:

(1) Last Saturday, the Chinese Ministry of Science and Technology released a new directive titled "Instructions on strengthening biosecurity management in microbiology labs that handle advanced viruses like the novel coronavirus." Mosher observes that only the WIV fits that bill, having China's only Level 4 microbiology lab that is equipped to handle deadly coronaviruses.

(2) Mosher reported, "The People's Liberation Army's top expert in biological warfare, a Maj. Gen. Chen Wei, was dispatched to Wuhan at the end of January to help with the effort to contain the outbreak. According to the PLA Daily, Chen has been researching coronaviruses since the SARS outbreak of 2003, as well as Ebola and anthrax."

(3) According to Mosher, Chinese officials first blamed Wuhan's seafood market "even though the first documented cases of Covid-19 (the illness caused by SARS-CoV-2) involved people who had never set foot there. Then they pointed to snakes, bats and even a cute little scaly anteater called a pangolin as the source of the virus. I don't buy any of this. It turns out that snakes don't carry coronaviruses and that bats aren't sold at a seafood market."

CALENDARS

US: **Tues:** Consumer Confidence 132.0, Richmond Fed Manufacturing Index 10, S&P Case-Shiller 20-City Home Price Index 0.4%*m/m*/2.9%*y/y*. **Wed:** New Home Sales 713k, MBA Mortgage Applications, DOE Crude Oil Inventories. (DailyFX estimates)

Global: **Tues:** Germany GDP 0.0%q/q/0.4%y/y, Lane. **Wed:** Lagarde. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings ([link](#)): Forward earnings fell for two of these three indexes last week. LargeCap's was up for the 11th time in 14 weeks. MidCap's and SmallCap's were down for the third time in 14 weeks as MidCap dropped for a second week and SmallCap registered a third straight decline. These indexes began a forward-earnings uptrend during March 2019 but stumbled from July to November. LargeCap's forward earnings has risen during 39 of the past 53 weeks, MidCap's 30 of the past 49 weeks, and SmallCap's 28 of the past 47 weeks. While LargeCap's is just 0.1% below its record high, MidCap's and SmallCap's are 3.0% and 5.2% below their October 2018 highs. Index changes for the SMidCaps at the end of 2019 helped MidCap's forward earnings improve from November's 18-month low, while SmallCap's is up from September's 17-month low. The yearly change in forward earnings soared to cyclical highs during 2018 due to the boost from the Tax Cuts and Jobs Act but began to tumble in October 2018 as y/y comparisons became more difficult. In the latest week, the rate of change in LargeCap's forward earnings improved to 4.3% y/y from 4.1%, which compares to an eight-month high of 4.4% at the end of January and a 38-month low of 1.0% in early December. That's down from 23.2% in September 2018, which was the highest since January 2011. MidCap's weakened w/w to -0.4% y/y from a five-month high of -0.2% a week earlier, and compares to -5.5% in mid-November, which was the lowest since December 2009. That also compares to 24.1% in September 2018 (the highest since April 2011). SmallCap's improved w/w to a nine-month high of 1.1% y/y from 0.7%; that's up markedly from -9.6% in mid-September, which was the lowest since December 2009 and compares to an eight-year high of 35.3% in October 2018. Analysts had been expecting double-digit percentage earnings growth for 2019 during late 2018, but those forecasts are down substantially since then. Here are the latest consensus earnings growth rates for 2019, 2020, and 2021: LargeCap (0.7%, 7.8%, 11.4%), MidCap (-6.3, 11.1, 10.9), and SmallCap (-0.4, 10.6, 14.2).

S&P 500/400/600 Valuation ([link](#)): Valuations moved lower last week for these three indexes. LargeCap's forward P/E fell w/w to 18.7 from 18.9, which had been the highest level since June 2002 and compares to a five-year low of 13.9 during December 2018. Of course, that's still well below the tech-bubble record high of 25.7 in July 1999. Last week's level compares to the post-Lehman-meltdown P/E of 9.3 in October 2008. MidCap's forward P/E dropped w/w to 17.2 from 17.3. That's up from 13.0 during December 2018, which was the lowest reading

since November 2011. MidCap's P/E is down from a 22-month high of 17.4 in mid-December and the record high of 20.6 in January 2002. However, MidCap's P/E has been at or below LargeCap's P/E for most of the time since August 2017—the first time that alignment has prevailed since 2009. SmallCap's P/E decreased w/w to 17.3 from 17.6, and is down from mid-December's 16-month high of 18.1. That's well above its seven-year low of 13.6 during December 2018 and compares to its 15-year high of 20.5 in December 2016, when Energy's earnings were depressed. SmallCap's P/E is also below LargeCap's. It had been below for four months through the end of August—the first time that has happened since 2003.

S&P 500 Sectors Quarterly Earnings Outlook ([link](#)): With the bulk of December quarter-end companies having already reported Q4 earnings, earnings revisions activity should begin to slow. The blended Q4 EPS forecast rose 7 cents w/w to \$42.00. That represents a gain of 2.0% on a frozen actual basis and an increase of 3.2% y/y on a pro forma basis. That compares to a 0.3% decline in Q3 and y/y gains of 3.2% in Q2, 1.6% in Q1, 16.9% in Q4-2018, and 28.4% in Q3-2018 (which marked the peak of the current earnings cycle). If the y/y earnings gain comes to pass in Q4-2019, it would mark a return to growth following Q3's drop, which was its first since earnings fell y/y for four straight quarters through Q2-2016. Eight of the 11 sectors are expected to record positive y/y earnings growth in Q4, with two rising at a double-digit percentage rate. That compares to seven positive during Q3, when none rose at a double-digit percentage rate. Six sectors are expected to beat the S&P 500's 3.2% gain in Q4; down from seven in Q4 but up sharply from just three beating the S&P 500 during Q2. Six sectors are expected to post improved growth on a q/q basis during Q4: Communication Services, Financials, Health Care, Real Estate, Tech, and Utilities. On an ex-Energy basis, the consensus expects earnings to rise 6.1% y/y in Q4. That compares to ex-Energy gains of 2.2% in Q3, 3.9% in Q2, and 3.0% in Q1 but is well below ex-Energy's 25.0% and 14.2% y/y gains in Q3-2018 and Q4-2018, respectively. Here are the latest Q4-2019 earnings growth rates versus their final Q3-2019 growth rates: Utilities (16.7% in Q4-2019 versus 6.7% in Q3-2019), Financials (12.4, 2.6), Health Care (9.8, 8.8), Communication Services (8.1, -1.4), Information Technology (8.8, -1.7), Real Estate (6.2, 5.9), Consumer Staples (2.5, 3.7), Consumer Discretionary (0.6, 1.8), Industrials (-9.1, 3.4), Materials (-12.4, -10.9), and Energy (-40.7, -37.8).

US ECONOMIC INDICATORS

Regional M-PMIs ([link](#)): Three Fed districts have now reported on manufacturing activity for February—Philadelphia, New York, and Dallas—and show growth accelerating at the fastest

clip since October 2018, boosted by a sharp acceleration in both the Philly and New York regions; the Dallas region showed little growth. The composite index jumped to 16.9 this month from 7.2 and 0.8 the prior two months, as both the Philly (to 36.7 from 17.0) and New York (12.9 from 4.8) regions improved notably—though Philly is growing at triple the pace of New York. Meanwhile, the composite index for the Dallas (1.2 from -0.2) region remained weak, but moved into positive territory for the first time in five months. Orders were the strongest since July 2018, improving for the third month, from 3.4 in November to 21.4 this month. Billings in the Philadelphia (33.6 from 18.2) and New York (22.1 from 6.6) regions were the best since May 2018 and September 2017, respectively, while Dallas' (8.4 from 17.6) eased from January's 15-month high. In the meantime, employment increased at half the pace of last month, slipping to 5.2 from 10.1 in January—with manufacturers in the Philly (9.8 from 19.3) and New York (6.6 from 9.0) regions hiring at a slower pace; manufacturers in the Dallas (-0.9 from 1.9) region failed to add to payrolls for the first time since the end of 2016.

GLOBAL ECONOMIC INDICATORS

Germany Ifo Business Climate Index ([link](#)): “The German economy seems unfazed by the developments around the coronavirus,” said Ifo President Clemens Fuest. “The survey results and other indicators suggest economic growth of 0.2% in the first quarter.” However, the story is likely to be different in March, as concerns about the coronavirus are mounting, triggered by the emergence of outbreaks in several countries outside of China—the latest being Italy. Germany's Ifo Business Climate Index ticked up from 96.0 in January to 96.1 this month, holding around December's six-month high of 96.3; it bottomed at 94.5 in August. The expectations component (to 93.4 from 92.9) nearly reversed January's decline from December's six-month high of 93.9; it bottomed at 90.9 last September. The present situation component (98.9 from 99.2) has been in a flat trend around 99.0 since last September. Across sectors, sentiment among manufacturers (to -1.3 from -1.6) continued to improve, while confidence within the service (17.3 from 18.8), trade (1.0 from 2.2) and construction (13.1 from 13.5) sectors weakened this month.

Contact us by [email](#) or call 480-664-1333.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
Debbie Johnson, Chief Economist, 480-664-1333
Joe Abbott, Chief Quantitative Strategist, 732-497-5306
Melissa Tagg, Director of Research Projects & Operations, 516-782-9967

Mali Quintana, Senior Economist, 480-664-1333
Jackie Doherty, Contributing Editor, 917-328-6848
Valerie de la Rue, Director of Institutional Sales, 516-277-2432
Mary Fanslau, Manager of Client Services, 480-664-1333
Sandy Cohan, Senior Editor, 570-775-6823

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