Nothing to Fear but Fear Itself? Thoughts on Covid-19 and its Market Impact.

All data and statistics quoted are as of February 25th, unless otherwise stated.

Financial markets have taken a dramatic turn for the worse this week, with stock markets selling off sharply and generally indiscriminately across the globe. At the time of writing (February 25), the MSCI All-Country World Index is down 6% since last Wednesday, with stocks across Developed Markets (DM) and Emerging Markets (EM) registering like-sized declines while all industrial sectors are in the red — and market interest rates retesting their record low levels amid safe haven demand for bonds.

The catalyst for this rise in investor risk aversion is concern over the spread of the novel coronavirus. In the comments that follow, without denigrating or belittling the serious nature of the illness and those affected, we would like to offer analysis on how global issues such as this can generate activity in the markets that is fear-based and will likely be short-lived or even reversed within a short period of time once the situation is more controlled.

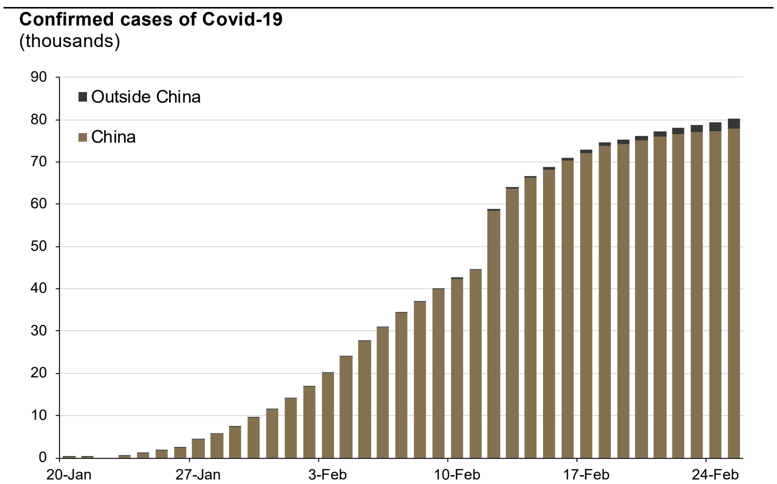
The disease (called coronavirus disease 2019 or "Covid-19" for short) originated in Wuhan, a metropolis of 11 million in the Hubei province in central China where it was believed to have originally passed from live animals to humans at a market. Covid-19 causes respiratory issues such as coughing, breathing difficulties and fever that can range from mild to severe, and can escalate into pneumonia and multi-organ failure. People with the virus are most contagious showing symptoms but they can also transmit the disease during the 2- to 14-day incubation period, albeit the risk of this is currently viewed as very low.

The first reported cases were on December 30, 2019 and at the time of writing (February 25), the World Health Organization (WHO) reports that there are 80,236 confirmed cases of which the vast majority are in China (77,780 or 97% of the total).

While many officials have been flagging the likelihood that the disease would spread widely from very early on, financial markets have been spooked this week by the fact that the number of cases across the world has doubled since Friday with 2,459 confirmed cases now in 34 countries.

The increase is no doubt alarming and raises concerns that this epidemic (an outbreak of disease that attacks many people at about the same time and may spread through one or several communities) is on the verge of turning into a pandemic (an epidemic that spreads throughout the world), which would carry broader fallout. But, that said, as mentioned above, some context is warranted here.

CHART 1: SPREADING OUT



Source: World Health Organization, Centre for Disease Control, Guardian Capital

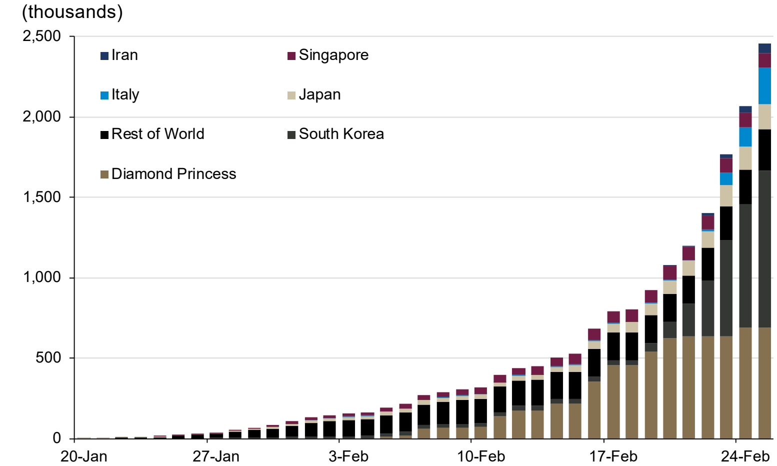
One important fact is that a significant chunk of these added cases outside of China have been found in a few specific locations, rather than being indicative of a broader proliferation. As per the WHO, there are now 691 confirmed cases aboard the Diamond Princess, a cruise ship with a total of 3,711 passengers that has been quarantined in Japanese territorial waters since February 5th — that is up from 454 a week ago and 10 at the time of the initial quarantine. As well, the surge in South Korea in recent days (946 new confirmed cases over the last week) has been tied back to a religious group based in the southeastern city of Daegu. Similarly, the increase in Iran (61 new confirmed cases since last Wednesday) has been concentrated in Qom, one of the country's main pilgrimage sites.

These clusters do not exactly suggest an aggressively and uncontained widening contagion as much as what would be expected among large groups in relatively confined spaces like places of worship or cruise ships — and South Korea, Iran and the Diamond Princess account for two-thirds of all cases outside China, and three-quarters of the increase over the past week.

With that said, there has been an increase in confirmed cases in other areas and the outbreak is expected to continue to spread before it is contained. The question is, though, does that likelihood and the potential negative risks associated with it warrant what has been playing out in financial markets — and is there reason to expect that things will continue to spiral downward into a deeper downturn?

CHART 2: BEYOND BORDERS

Confirmed cases of Covid-19 outside of China
(thousands)



Source: World Health Organization, Centre for Disease Control, Guardian Capital

On this score, it appears that the fear in the marketplace is less a function of a real fundamental shift in the global economic backdrop and more a product of fear itself. More specifically, barring any sort of mutation or material escalation of the threat (which has still not reached pandemic level as per the WHO), the impact from the loss of life related to this outbreak is not likely to generate significant permanent disruptions.

Obviously, the loss of life is tragic no matter the number, but in gauging the overall macroeconomic impact, some context is important. To date, there have been 2,700 deaths attributed to Covid-19 (2,666 in China, 34 elsewhere). Compare that to the Center for Disease Control's (CDC) estimates that the "standard" influenza impacted 35 million people and was responsible for more than 34,200 deaths in the United States alone just in the last flu season. The CDC estimates that at least 14,000 people have died of the flu in America so far this season (from October 1, 2019 to February 20, 2020).

What this means is that any economic impact is more likely to result from governments and businesses efforts to adjust activity to contain the spread of the virus (i.e. travel restrictions, temporarily shuttering operations, canceling public events) and fear-driven changes to consumer spending (i.e. less demand to be in public shopping centres or restaurants, reduced demand for travel and tourism) rather than a material collapse in demand. While negative for these industries' profits and economic growth in the short-term, spending is more likely to be delayed than completely lost forever.

Accordingly, once there is growing confidence that the virus is being contained and the spread is leveling off (something that is has been evident in China in recent days), activity will return to something akin to normal in fairly short-order, resulting in the vast majority of pent-up demand (and corporate revenues) being recouped.

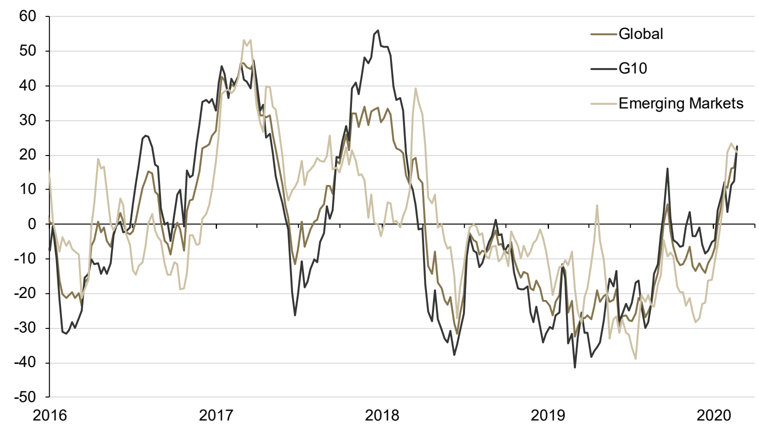
This is especially likely given that outside the outbreak and its hit to market sentiment, the underlying trends in the economic data have been increasingly positive. For example, the Citi Economic Surprise Index (an indicator of data outturns versus consensus forecasts) shows that the dataflow in both DM and EM has been faring much better relative to expectations, outperforming consensus at a rate not seen since early 2018 when the narrative was all about the renewed, synchronized economic expansion.

As well, the composite leading indicator (a forward-looking gauge of economic momentum based on a broad swath of activity data) for the 36 DM economies that make up the Organisation for Economic Co-operation and Development (OECD) and six other major EM economies, has been increasing in recent months in a sign that economic momentum had swung to positive for the first time since the end of 2017.

In other words, while the impact of the virus-related disruptions could be significant in areas where the epidemic is most acute (namely, in China, especially given the outbreak interrupted Lunar New Year celebrations), the impact more broadly is likely to be relatively short-lived and carry little by way of lasting impact, let alone appear to prove sufficient to push the global economy into a deep recession.

CHART 3: EXCEEDING EXPECTATIONS

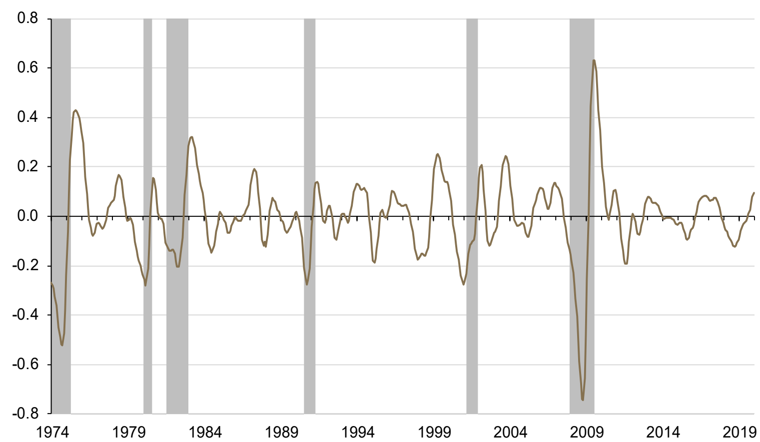
Citi Economic Surprise Index
(percent; >0 denotes reports exceeding expectations)



Source: Bloomberg, Guardian Capital. Weekly data as of February 21, 2020.

CHART 4: THE PENDULUM SWINGS POSITIVELY

OECD+ Composite Leading Economic Indicator
(month-over-month percent change)



Shaded regions represent periods of US recession
Source: OECD, Bloomberg, Guardian Capital. Monthly data as of December 31, 2019.

Such an outcome would be consistent with previous outbreaks, with research on instances ranging in severity from severe acute respiratory syndrome (SARS; which had 8,096 cases globally and resulted in 774 deaths) in 2003 to the Spanish Flu in 1918 (which inflicted nearly a third of the world's population and killed 40 million people worldwide) suggesting that the overall economic impact is typically short-lived and fairly limited — and looking at recent experiences with pandemics, the market shocks are all but forgotten in six months' time.

TABLE 1: BEEN THERE, DONE THAT

MSCI All-Country World Index Trailing Returns (%) Following First Reported Case

	1 week	2 weeks	1 month	3 months	6 months
Avian flu (1997)	0.9	1.9	3.3	13.0	5.2
SARS (2003)	2.5	3.4	-0.3	-9.5	0.1
H1N1 (2009)	-0.4	2.0	5.2	5.3	25.0
Ebola (2014)	1.7	1.0	2.1	6.0	7.4
COVID-19 (2020)	0.3	1.6	0.2		

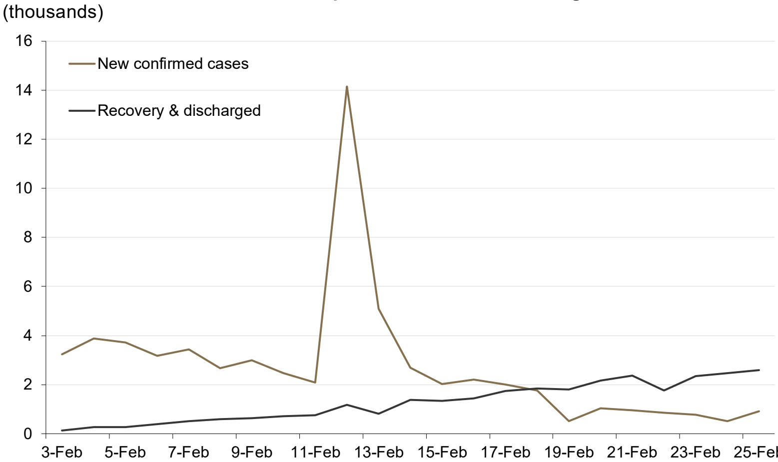
Source: Bloomberg, Cornerstone Macro, Guardian Capital. Performance is for trailing period since first reported cases for Avian flu (May 9, 1997) SARS (November 15, 2002), H1N1 (April 15, 2009), Ebola (March 24, 2014), and Covid-19 (December 30, 2019)

Moreover, there is reason to anticipate that the spread will be somewhat mitigated in terms of its reach and duration. Since we have been through this exercise before — before SARS, there was the avian flu in the late 1990s and we more recently had the experience of H1N1/swine flu outbreak in 2009 — there are protocols in place that have resulted in increased public awareness and better practices among healthcare professionals and government agencies that can serve to lessen the overall impact.

Indeed, some solace can be taken by the fact that not only has the pace of increase in new diagnoses of Covid-19 slowed over the last week (mainly reflecting the moderation within China in no small part due to the actions of the Chinese government to effectively quarantine entire cities, something that would likely prove far less successful in Western economies, but has been credited with averted a significant number of new cases) but the rate of recovery & hospital discharge of those once stricken with the disease has been accelerating and outpacing the new cases, meaning the actual number of existing cases has actually been declining.

CHART 5: PATIENT EBB & FLOW

New confirmed cases of Covid-19 & patient recoveries/discharges
(thousands)



Source: World Health Organization, Centre for Disease Control, Guardian Capital

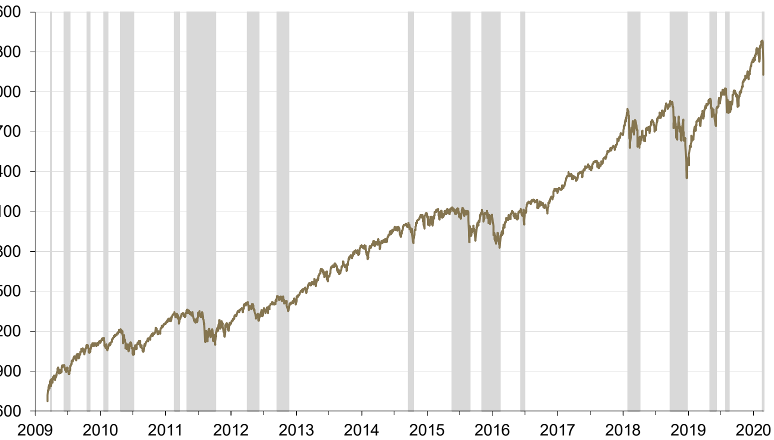
The bottom line is that while the situation is clearly fluid and there is potential for everything to take a turn for the worse, as of now there still remains little reason to anticipate that the baseline will be materially worse than what has transpired in previous similar situations. The global economic expansion will likely continue and this will likely just prove to be another brick in the wall of worry that markets ultimately climb.

Of course, in the near-term, volatility is likely to persist against elevated headline risk and a break lower still is entirely possible. Importantly, though, any such moves are likely to prove temporary and unlikely to spur on a fundamental bear market. Instead, we are in simply in the midst of a sentiment-driven market correction, the 18th of this bull-run and it comes six months since the last one, which happens to be bang on the average this cycle.

This too shall pass.

CHART 6: CLIMBING THE WALL OF WORRY

S&P 500 composite price index
(index)



Shaded regions denote periods of peak-to-trough declines in excess of 5%
Source: Bloomberg, Guardian Capital

The MSCI All-Country World Index captures large and mid cap representation across 23 DM and 26 EM countries. The S&P 500 captures the performance of 500 large capitalization U.S. companies. The Citi Economic Surprise Index is an indicator of data outturns versus consensus forecasts. The OECD+ Composite Leading Indicator is a forward-looking gauge of economic momentum based on a broad swath of activity data.

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