OUR FAMILY PERSPECTIVES

INSIGHTS FROM CANADA'S LEADING FAMILY OFFICE

Coronavirus Market Update - March 4, 2020

The complacency that financial markets had been showing to the growing threat of the coronavirus was shattered in dramatic fashion last week, with the equity markets experiencing the fastest weekly decline since 2008. Stock markets around the world dropped as investors grappled with this new uncertainty. Since February 19 through yesterday's closing, the TSX Composite fell -7.9%, the S&P 500 dropped -10.8%; the MSCI EAFE Index fell -9.5%, and the MSCI Emerging Markets Index declined -5.5%.

What changed? Until last week, most observers believed the virus would be largely contained within China's Hubei Province, the source of the original outbreak. China's efforts to restrict travel to an area populated by more than 50 million people was seen as an effective, if belated attempt to control the spread of the virus. Indeed, the number of new cases appearing in China has fallen dramatically in recent days, indicating some success in controlling the outbreak. Until last week, more than 99% of all reported cases were in China.

Then last Tuesday things changed. Officials at the U.S. Center for Disease Control (CDC) issued a warning about the inevitability of the spread of the virus and reports started identifying new cases in several countries around the globe. While it is important to recognize that fears about a "global pandemic" are spreading faster than the virus itself, the past week highlighted that the virus is far from contained; rightly or wrongly, investors had not previously *perceived* this to be the case. Accordingly, the spread of coronavirus is now causing a reset of expectations for global growth and corporate earnings for 2020. Consumer and corporate spending, and thus the supply lines as well, will be affected for at least the next few months. Moreover, the market selloff is reflecting these adjusted expectations in an exacerbated manner due to the market's recent strong performance and elevated valuation levels.

Until last week, equity markets were priced for a rebound in corporate profits and a modest recovery in global growth. Interest rates were viewed as quite low, incenting businesses and consumers to borrow and spend, and providing little competition to stocks for investor dollars. Last year global equities returned 27% on average, and the rally continued through the first half of February. The bullish outlook was supported by improving momentum in global earnings and the easing of some of the trade conflicts that worried investors for the last two years. As the year came to a close, valuations were about 15% ahead of long-term averages. While not priced for perfection, equity markets were far from contemplating a rapid deceleration in global growth.

Positively, fiscal and monetary authorities reacted to last week's pronounced weakness by announcing coordinated stimulus aimed at backstopping global growth and preventing continued panic selling in markets. As part of this, the U.S. Federal Reserve took the unexpected step of cutting interest rates by 0.5% in an emergency meeting yesterday. These meetings take place between planned committee meetings and occur very infrequently. Ominously, the last time the Fed cut rates in this fashion was October 2008 as the world spiralled into financial crisis, prompting investors to ask, "Are things that bad now too?" Fear and emotion again took over and U.S. stock markets finished yesterday day about 3% lower while the 10yr U.S. Treasury yield broke below 1% for the first time in history on a flight to safety.

More important than what happened in markets is why it happened. Bottom line, markets do not like uncertainty, and the coronavirus has dramatically increased the amount of uncertainty facing business leaders and markets. No one can predict whether the virus will become a long-term and dangerous global problem forcing people into mass quarantine; listening to such doomsday predictions is simply not helpful. Nor is it reasonable to suggest we know exactly when it will be over. And no economist can say precisely how significant the impacts will be, because it's highly uncertain how individuals will change their behavior in light of this virus.

While uncertainty is bad for markets, it's important for investors to understand that uncertainty can run both ways. Indeed, this is exactly the time investors need to be unemotional and stick to their process, absorbing good information and tuning out the noise. This is not a time to change your long-term investment program and sell stocks, because the potential for good news is also actually quite large. For example, some research suggests the virus dies around 26-27 degrees Celsius, likely making its lifespan similar to other seasonal flu viruses. If accurate, this would suggest present growth and earnings declines are only short-term in nature and not indicative of long-term asset impairment. Sentiment is a significant driver of short-term market movement, and positive news about the containment of the virus could result in a powerful relief rally. At the same time, as ugly as this week has been for investors, recognize that this selloff has only returned the S&P 500 to levels seen last October.

In the days and weeks to come, we will continue to assess short-term versus long-term economic effects and model potential scenarios for the global economy as we learn more about the coronavirus and its impact. We will be speaking with you in the event we recommend any changes to your asset allocation program or individual managers as a result of these analyses.

At times like these, however, it's important to recognize that we are witnessing one of the critical underpinnings of why we construct "All-Weather" investment portfolios, which include a prudent allocation to global equities. The short-term return on equities is highly uncertain, and therefore markets respond poorly when uncertainty increases. But it is precisely due to this feature that they have historically returned more for investors then other asset class. Conversely, the volatility we are experiencing now is exactly why investors are more richly compensated for holding equities.

The key question investors should ask is: what is the appropriate allocation to an asset class with higher short-term risks but higher long-term rewards? Every client's situation is different, which is why we contemplate all family-specific details when determining individual asset allocation programs. Within every program there is a greater or lesser allocation to global equities, balanced by an array of globally diverse best-in-class managers overseeing allocations to other asset classes within the program. This asset class and manager diversification is responsible for improved capital protection and risk-adjusted returns and thus it's very unlikely any family's portfolio dynamics will have changed as a result of recent news.

As always, Our Family Office is closely monitoring this fluid situation. We will endeavour to update you on a regular basis and upon any notable developments. In the meantime, please do not hesitate to reach out with any questions or concerns.

Neil Nisker - Executive Chairman & CIO
Our Family Office, Inc.

Cameron Hurst – Managing Director
Global Investment Strategies
Our Family Office, Inc.

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