Return of The Exogenous Shock

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As we enter the worst stock selloff of this relatively young year – triggered primarily by Coronavirus fears and its negative impact on the crucial Chinese economy and supply chain – we think it is important to take a step back and gauge the risk-reward for securities markets for the foreseeable future. And, in the spirit of leading with our conclusions, we continue to think that high quality diversified portfolios are investors' best defense against these occasional bouts of volatility. In particular, for long-term investors (as opposed to traders), we believe the relative value of high quality dividend growing stocks remains very attractive versus the bond market, despite North American indices still within striking distance of record highs.

The purpose of this missive is not to try to predict when this nascent epidemic will be contained, but rather to provide some perspective. First, the common flu, which does not generate headlines, typically kills hundreds of thousands per year (and over 8,000 in the U.S. alone this season), while less than 3,000 people have died from COVID-19 at this point. The fact that there is no approved vaccine for the Coronavirus (although several are in development) just adds to the fear. History suggests that the markets rebound relatively quickly from extraneous shocks (i.e., armed conflicts, epidemics). Given the stock market is a discounting mechanism which leads the real economy, past episodes of epidemics suggest that the market tends to bottom when the news is seemingly at its worst (i.e., with the peak in new cases). Looking at a few "ground zero" stocks, it is also interesting that cruise line companies and McDonald's rebounded relatively quickly from the SARS/MERS and Mad Cow scares, respectively. The following charts illustrate the point:

Figure 1: Historical Market Returns vs. Epidemics

Epidemic	Month End	6-Month % Change of S&P 500	12-Month % Change of S&P 500
SARS	April 2003	14.59	20.76
Avian Flu	June 2006	11.66	18.36
Swine Flu	April 2009	18.72	35.96
MERS	May 2013	10.74	17.96
Ebola	March 2014	5.34	10.44
Coronavirus	?	0.51**	

**January 21, 2020 - February 24, 2020

Source: Dow Jones Market Data

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Figure 2: Hong Kong Stock Index vs. SARS News Count

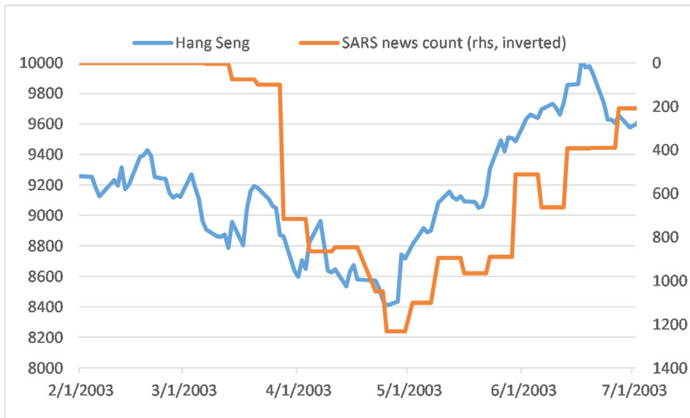
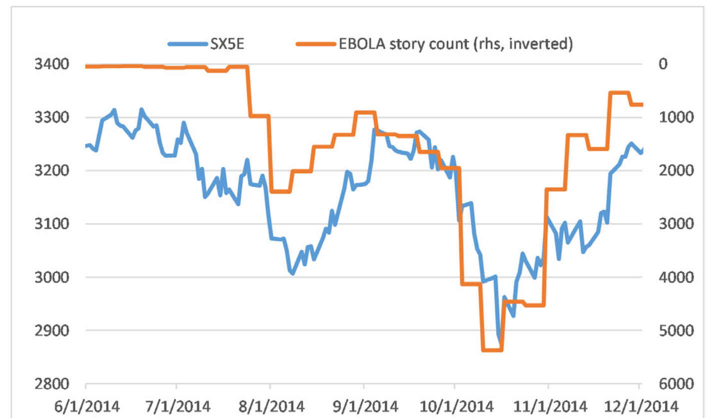


Figure 3: European Stock Index vs. Ebola Story Count



Source: JPMorgan

Figure 4: RCL and CCL vs. SARS

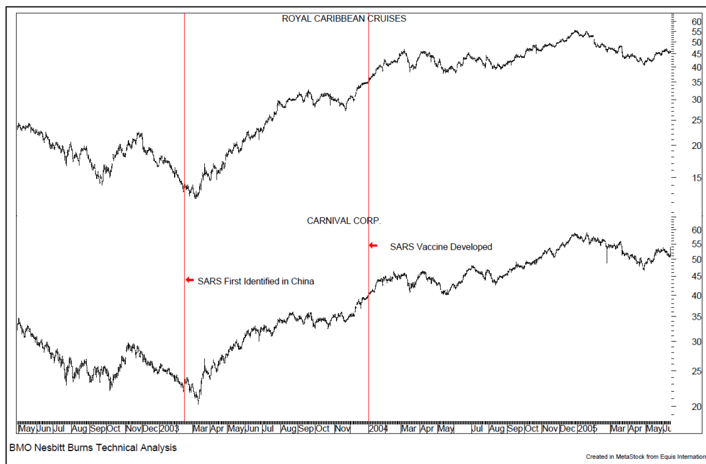
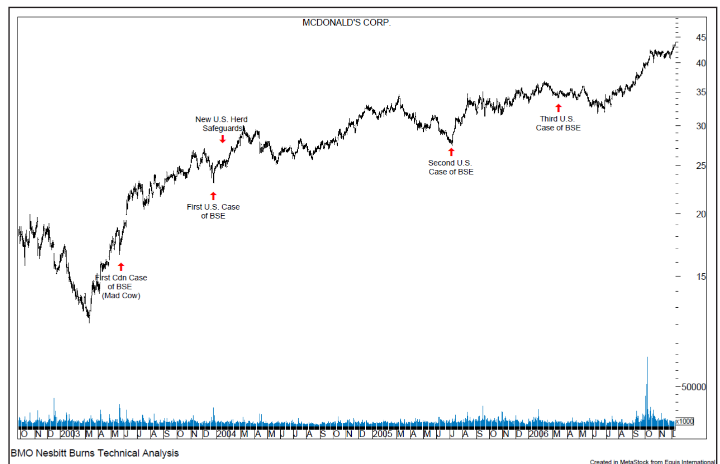


Figure 5: MCD vs. Mad Cow Cases



Source: BMO Nesbitt Burns Portfolio Advisory Team

As interest rates continue to make new lows, some bearish observers think this could be a sign of a dramatic growth slowdown around the corner. We do not subscribe to that view. In fact, global economic momentum was starting to turn positive before the onset of the Coronavirus. While there is no certainty how quickly it will be contained, BMO Economics continues to think that 2020 will see reasonably strong global growth of 2.6%, assuming the virus is contained by April. For Canada, they expect 1.7% down from 1.8% at the start of the year due to the rail blockades.

Critically, lower interest rates – and by extension mortgage rates – are highly supportive for the huge real estate market and consumers, and for the present value of future corporate cash flows (meaning the fair value of stocks goes UP). In fact, our analysis going back to 1980 shows that the average annualized S&P 500 return has been over 16% when 10-year bond yields have been this low. This is largely consistent with the conclusion of our BMO Nesbitt Burns Recession Probability Model[1]. This model shows a relatively low 33% probability for a North American recession in the next year given the strength in employment and improvement in trade tensions. In other words, the odds of a severe economic contraction and associated bear market in stocks have not materially increased since we introduced the Model in May of last year.

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Senior Technical Analyst, Russ Visch, adds that in his work there are essentially two types of indicators: general barometers of market health, and timing. The former gives you a sense of what the risks are for a real bear market (15-20%+) occurring. As we reach the final stretch of the first quarter, these structural "canaries in the coal mine" are about as healthy as they ever get. Advance-decline lines recently made new all-time highs, bond market indicators (such as corporate credit spreads which measure the additional cost for corporations to borrow versus governments) recently made 52-week or multi-year lows, and market-based measures of the economy (semiconductors, South Korean Kospi Index, and industrial/commercial commodities) also continue to improve. Most of these gauges began to deteriorate 3 to 6+ months ahead of the late 2018 cyclical bear, so the fact that they are all still improving suggests the threat of a real bear in the first half of 2020 is virtually nil.

As always, we strongly recommend against overreacting to the current bout of volatility. The key is to maintain a well diversified portfolio, including bonds, cash and high quality stocks.

Please contact your BMO financial professional if you would like to discuss your investment portfolio.

[1]Our Model has provided an important warning on every upcoming U.S. recession (and, by extention, most Canadian recessions) since 1950, with a lead of two to three quarters. This is important because the market is a leading indicator and discounts improving and worsening business cycles in advance. Remember, it is when our one year probability rises above 50% that we get a powerful "risk off" signal that argues in favour of lowering the equity allocation of portfolios.

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