Federated Hermes

I never get sick...

As news about the virus vacillates, so does the bond and stock markets′ reactions.

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... and that's because I wash my hands religiously and get a flu shot every year!! Last weekend, I caught the flu (no, not the corona), thus squelching planned Florida meetings for the week. When you're down with the flu, and it seems a chore just to visit the restroom, you take the coronavirus more seriously than you did last week. Even as the number of cases appears to be declining in China, virus damage is sure to linger for months. China is suffering an economic heart attack. It has shut down an industrial hub of 11 million, curtailed travel for hundreds of millions and is being further isolated by some countries in terms of trade and people movement. Nearly half of companies surveyed by the American Chamber of Commerce in Shanghai say they've been impacted by virus-related shutdowns, 78% said they don't have sufficient staff to run full production lines and 58% expect lower-than-normal demand for at least the next few months. Treasuries are pricing in a significant hit to 2020 growth (though nothing remotely close to a recession), followed only by a partial rebound in 2021. The term premium (the yield "bonus" investors receive on longer-term bonds vs. short-term Treasuries) is on the downswing again, suggesting the bond market expects things to get worse before they get better. While structural factors such as demographics, low neutral rates and very low rates abroad have driven the term premium down over the last few years, its recent move is all about the virus. Before the outbreak, the global outlook was improving and term premium was on the rise.

While bonds are very serious, the stock market is looking over the valley. Momentum and low-volatility stocks have rallied during the epidemic, pushing the valuation spread between defensive and cyclical stocks to a level that's twice as wide as the late-'90s tech bubble peak. Tech and health-care stocks that led pre-virus gains are again powering the S&P 500 to new highs, abetted by Beijing's decision this week to apply another meaningful dose of fiscal and monetary stimulus. But Utilities and Real Estate are doing well, too—they're the second- and third-best sectors year-to-date—and participation is broad. While the market is being driven by the mega-cap FANMAG stocks (Facebook, Apple, Netflix, Microsoft, Amazon and Alphabet), the S&P *ex-Tech & Communication is at a new high*. The NYSE advance-decline (A/D) line also is at a new high (the A/D line historically has tended to peaked about 100 market days prior to new market highs), and roughly four of every five issues are above their respective 200-day moving averages. The S&P and Nasdaq closed at new highs Wednesday, aided by large weights in bond proxy stocks and growth sectors that are benefiting from falling yields, and the trend remains positive. Near-term S&P support is at 3,250 and internal trends are the strongest they've been in years. Globally, sentiment is starting to run hot again. Even the Shenzhen market has rebounded.

Whether bond yields remain lower for longer could depend on the magnitude of the downdraft in China's growth. That may not come with any semblance of certainty until April at the earliest. Some believe the panic could push Q1 global growth close to contraction, a concern that has spawned a 1.3 standard-deviation decline in global bond yields and an even bigger 2 standard-deviation drop in commodities. But despite the data likely getting much worse before they get better, equity markets already have recovered, which makes sense if the mechanics of the shock are V-shaped, the spread of the virus is contained soon and central banks and governments react with stimulus. Why does this matter? A shift in sentiment from bad to good following the SARS and Ebola health scares helped drive 10-year Treasury yields up 113 and 71 basis points, respectively, within two months after those health scares waned. After dropping 40 basis points to 1.54% from virus fallout fears, the 10-year yield could rebound just as quickly if those fears wane. As to the virus, Evercore ISI suggests, “the probability of near-term ‘good news’ about the outbreak is not 0%.” Now that’s the spirit! I’m scheduled to travel through North Carolina next week. No problem. I’m working on a V-shaped recovery.

POSITIVES

- **A good sign for the back half** Housing, which tends to lead the broader economy by nine months, is off to a strong start in 2020, with the year-over-year (y/y) pace of single-family starts and permits running at 2007 levels and builder confidence holding near a 21-year high. Also this morning, Conference Board leading indicators jumped in January, lifting the 6-month average back into expansion.
- **More signs that manufacturing has made a bottom** The Philly and New York Fed gauges of manufacturing activity in their respective regions shot up in February, with the former reaching a 3-year high and the latter a 9-month high. Notably, new orders surged in both surveys.
- **Contrarian positive** Forward revisions on industrial stocks have been as bad as they were was just before 2016’s steep slump, helping explain why they’ve struggled to break out despite the trough in manufacturing PMIs. To the extent the bar’s been lowered for the full

year, it could be a good thing for potential beats in coming quarters, particularly if virus worries ease and production picks up.

NEGATIVES

- **Global virus watch** Germany's ZEW survey showed the nascent recovery in its economy is at risk from the virus shock, as both current and expectations components slid deeper into negative territory. The broad survey on issues ranging from the economy to stock prices historically has served as an excellent global growth barometer.
- **Producer prices jump** January's producer price index rose the most in more than a year, and the core rate also surprised. On a y/y basis, the headline 2.1% increase doubled the pace from three months ago, but the core rate was still a subdued 1.7%.
- **The Boeing drag** Largely due to cutbacks at the aircraft manufacturer, January industrial production fell for the fourth time in five months, dropping the y/y decline in core production to a steep 1.1%.

WHAT ELSE

Call it a draw Vacillating virus news has opposite ends of the risk spectrum rallying. Sovereign bond prices have jumped, dropping global yields to 3-month lows, while global equity markets are setting fresh new highs, gold is at new cycle highs and the dollar vs. a common basket of currencies is nearing a 2-year high.

Fed in a freeze Virus-related uncertainty is constraining the central bank, upping the odds of additional rate cuts over the coming months and diminishing the possibility of any withdrawal/taper of balance sheet expansion in Q2. By Q3, the election may be too close for it to perform any policy action that might even remotely resemble tightening.

It's a race Actually, it's two: Bernie's to capture enough delegates before moderate Dems winnow down to one, and the virus' to die down before China's troubles infect the whole world. The former got a lot more interesting after Wednesday night's combative Nevada debate, while the latter seems to be shifting from news of a slowdown in China to new cases cropping up elsewhere.

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DISCLOSURES

Views are as of the date above and are subject to change based on market conditions and other factors. These views should not be construed as a recommendation for any specific security or sector.

Bond prices are sensitive to changes in interest rates, and a rise in interest rates can cause a decline in their prices.

Nasdaq Composite Index: An unmanaged index that measures all Nasdaq domestic and non-U.S.-based common stocks listed on the Nasdaq Stock Market. Indexes are unmanaged and investments cannot be made in an index.

Producer Price Index (PPI): A measure of inflation at the wholesale level.

S&P 500 Index: An unmanaged capitalization-weighted index of 500 stocks designated to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Indexes are unmanaged and investments cannot be made in an index.

Standard deviation is a historical measure of the variability of returns relative to the average annual return. A higher number indicates higher overall volatility.

The Conference Board's Composite Index of Leading Economic Indicators is published monthly and is used to predict the direction of the economy's movements in the months to come.

The Empire State Manufacturing Index gauges the level of activity and expectations for the future among manufacturers in New York.

The Federal Reserve Bank of Philadelphia gauges the level of activity and expectations for the future among manufacturers in the Greater Philadelphia region every month.

The Markit PMI is a gauge of manufacturing activity in a country.

The National Association of Home Builders/Wells Fargo Housing Market Index is a gauge of how well or poorly builders believe their business will do in coming months.

The New York Stock Exchange (NYSE) advance/decline line measures the ratio of advancing stocks to declining stocks.

The ZEW Indicator of Economic Sentiment polls financial experts to gauge whether they are optimistic or pessimistic about the subsequent six months.

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