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FEBRUARY 2020

Special Bulletin

CORONAVIRUS UPDATE: Not Out of the Woods Yet. Stay Invested.

Highlights

- The recent stock market sell-off appears to have as much to do with overly optimistic market sentiment, as it does from renewed concerns over the spreading coronavirus.
- Market complacency has been high, particularly over the impact on global/U.S. growth and earnings estimates. Complex international supply chains are being put to the test; with the virus representing a massive global supply shock.
- Nevertheless, our base case continues to be that the impact will be manageable for the US, and a little longer lasting on Asia/European economies. Admittedly, that base case is being tested with new infections appearing in places previously thought unlikely, and growing public fears which may impact spending and investment decisions.
- Containment is key. If governments can contain the virus, and it follows a pattern similar to past epidemics, we believe the effect on markets could be relatively short-lived. We are encouraged by the decisive action of policymakers to date.
- It's not yet time to add risk. The pullback in equities is creating the potential for attractive buying opportunities, but further downside is likely as markets begin to quantify the virus's impact on global sales and supply chains. We quantify our reasonable worst case as a "garden variety" recession, with implications noted herein.
- **Stay disciplined & stay invested, market volatility is normal. While we're watching the situation closely in case we need to adjust course, our late cycle playbook has constructed resilient portfolios of quality, durable assets to weather storms such as these.**

Overview

Renewed market volatility over the Coronavirus is understandable, given the tragic loss of human life, the spread of the disease beyond mainland China, and concerns about its impact on the global economy. Still, we believe it is important as investors to make a distinction between temporary market reactions driven by uncertainty and the fundamentals that drive market performance over the long term. History has shown that even when stocks have suffered a short-term hit from virus-related worries, they have tended to bounce back in the following months.

The extent to which markets are affected will ultimately depend on the length, depth and breadth of the impact caused by the outbreak to the global economy. Though it's too early to assess the virus's full implications, travel restrictions, temporarily shuttered factories, and supply chain disruptions appears to be having a significant effect on the Chinese economy, and to a lesser degree, US corporations with business interests in China, as well as global trade more broadly.

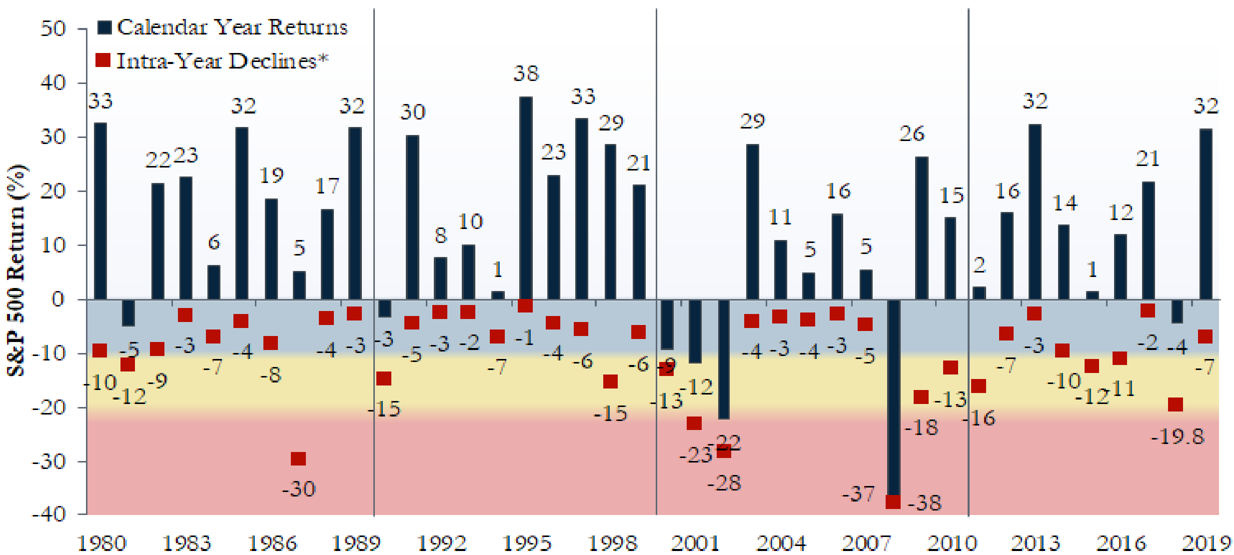
For now, we believe that the negative repercussions to US growth will be relatively minor and that recession risk remains low. The US is regarded as among the best nations in the world in terms of preparation and ability to respond to an epidemic, while it's largely domestic driven economy remains healthy and insulated somewhat from global headwinds. And, looking forward, it is important to recognize that much of the disruption in global economic activity ahead will not be a permanent loss, but rather merely postponed until business operations and consumer activity normalizes once the outbreak is contained.

While highly contagious, the mortality rate of coronavirus is thankfully relatively low in comparison to other recent outbreaks. As the prognosis for the virus changes and eventually improves, we expect markets will too, supported by continuing positive fundamentals of sustainable economic growth, rising corporate earnings and low interest rates. By keeping our focus on dividend paying U.S. stocks, select credit areas, and alternatives, we have positioned our portfolios to help withstand heightened uncertainty and minimize risk, yet continue to participate in ongoing gains.

Volatility Is Normal

Since the beginning of October, stocks as measured by the S&P 500, had been on quite a run, setting fresh record highs and rising 16% thru February 20. Given the circumstances, we've noted market volatility has been unusually low recently, complacency high, and that we wouldn't be surprised if we see a pullback or normal 5-10% correction at some point.

Even the best markets need a breather now and then. It's important to remember that significant drawdowns are normal, and often healthy in resetting stock valuations and investor expectations within a longer-term market advance. As of its February 25th close, the S&P 500 is -7.6% from its 2020 high, and despite the swiftness of the recent pullback, that is still less than the typical annual drawdown of -13%.



Source: Factset.

Market Outlook & Portfolio Strategy

We believe maintaining a portfolio of high-quality and dividend paying US companies is the best strategy in the current environment, and we continue to avoid developed markets that are more exposed to global headwinds. Although we estimate a significant impact on company profitability in China and other regions, we do not anticipate a material impact on U.S. companies in our portfolios. In addition, a review of our bond holdings has been conducted, and we do not foresee any risks to the quality of our fixed income portfolios. If the spread and implications of the coronavirus exceed our current projections, investment positioning across all client portfolios will be updated.

While new information on the coronavirus continues to arrive daily, the peak magnitude of the epidemic and the full extent of the economic implications are still unknowable at this point. Markets had appeared to be pricing-in a V-shaped recovery as the base case for the Chinese economy and global growth, but growing concerns over the longevity of the economic impact have affected risk assets in recent days. Encouragingly, reaction in credit markets has thus far been more benign, with spreads widening somewhat, but indicating more resilience in the outlook.

We continue to believe the fundamentals of economic growth, inflation, interest rates, and corporate profits point to further potential stock market gains this year. However, from a financial market standpoint, the tail risks of a more prolonged and higher magnitude disruption from coronavirus remain a risk to markets. As a result, we expect market volatility will stay higher in the near term, and further downside is possible, as investors continue to reassess the impact of coronavirus on economic and earnings growth.

For now, we continue to view the shock from coronavirus as transitory, an event that is less than six months long in its course for the epidemic and its effects. In the US, the expected impact to growth appears relatively minor and short-lived with most estimates shaving perhaps a total of 0.1-0.2% off GDP over the next two quarters. The situation globally is more challenging, particularly in China which is suffering the brunt of the impact from the virus. China is now the second largest economy in world, amounting to 16% of global GDP compared to just 4% when the SARS outbreak occurred in 2003, and much more integrated into the world economy.

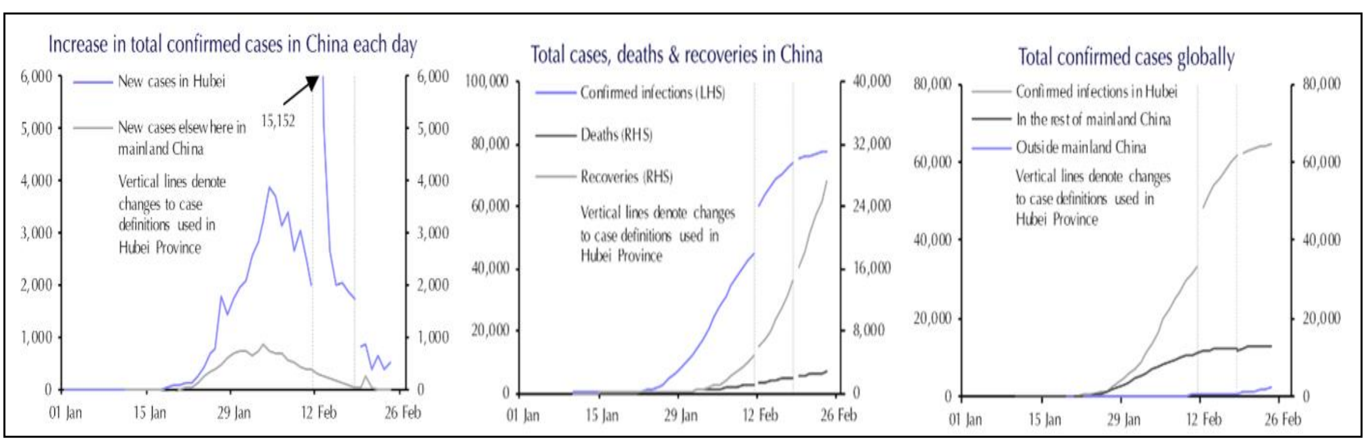
The good news is that the coronavirus outbreak has come at a time when the global economy has been shown early signs of rebounding growth, with an improvement in the international manufacturing inventory cycle, diminished Brexit and trade war risks, and a strong tailwind from last years synchronized monetary stimulus. Although global financial markets have turned very volatile on the outbreak, Purchasing Managers' Surveys and consumer sentiment in Europe and the U.S. have shown limited impacts at this point.

The course of equity markets in coming weeks will likely be determined by expectations for corporate profits. So far, consensus earnings estimates have held up relatively well on mostly upbeat guidance, and at the country level, it is important to note US revenue exposure to China is only 4.4%. Still, assessing the potential earnings impact of the outbreak is difficult at this point in time. Most companies that have reported results have said it was too early to determine the impact or offered no updates, while some lowered their outlooks. As corporations gain a better understanding of the impact to their bottom-line, we could see estimates fall further. There had been a general sense that the much-anticipated earnings recovery of 2020 would only be delayed by a quarter or two. Given this, it seems fair to assume the market has some more downside risk over the near-term as analysts reprice EPS estimates for Q1 and Q2.

While volatility is inevitable, our base case is that the market should eventually reconnect to the broader positive fundamentals. However, if the spread of the virus continues to accelerate, particularly in the US, and public fears continue to grow, there is potential for a meaningful impact to global growth. Rather than past virus outbreaks, a more appropriate analogs for guidance then may by the 9/11 terrorist attacks where some economic activity seemed to stop for a time, with people refusing to travel or go out. In that event, a mild and short recession is probably a reasonable template for expectations with stocks ultimately declining 20-30% before markets begin to recover. Although a low probability at this point, we view this scenario as a realistic worst case, and are prepared to take appropriate defensive actions should conditions deteriorate.

Containment is Key

Given the significant interconnectedness of today's global economy, it has always been naïve to believe the virus would not spread beyond China's borders. The epidemiology surrounding coronavirus though is still unclear, leaving open the question whether or not the outbreak will move more aggressively outside of China and become a pandemic. With the total number of Chinese cases already over 80,000, the increase in recent days of reported cases in South Korea, Italy and Japan is raising alarms.



Source: Capital Economics, CEIC Data.

The good news is that the number of new cases in China outside of the epicenter of Hubei province appears to have peaked and the official number within the province is showing signs of plateauing. In fact, we are seeing very early signs of recovery in Chinese economic activity and supply chains, with local government data on the restarting process suggesting that approximately 60% of all companies are already back to work as of this week.

The new risk is the potential for a large outbreak to develop somewhere else. For now, the number of infections globally remain relatively low, despite the recent uptick, and health officials at this point still do not believe an uncontained global spread of the virus is at hand. If other governments can manage to contain the coronavirus, and it follows a pattern similar to other past epidemics tracked by the World Health Organization, the effect on markets and economies could be relatively short-lived.

Historically, the number of confirmed cases in various epidemics typically has risen sharply for eight to 10 weeks, then peaked. Why coronavirus is so worrisome is that its long incubation period makes early detection difficult and allows infections to spread more easily. Given this, we are encouraged by the decisive action of health official to date, including the recent warning issued in the US by the CDC. Thanks to timely and sufficient medical care, the virus's fatality rate globally has been much lower than for those within the outbreak's epicenter – a significantly underreported development. In fact, according to the WHO, outside of Hubei, only around one in five infected people become severely ill, with the rest of confirmed cases exhibiting only mild symptoms.