CORONAVIRUS SURGES AND MARKET VOLATILITY FOLLOWS

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A surge of coronavirus cases outside of China is driving a pronounced flight to quality as investors evaluate the prospect that the viral outbreak will disrupt the global economy more than initially anticipated.

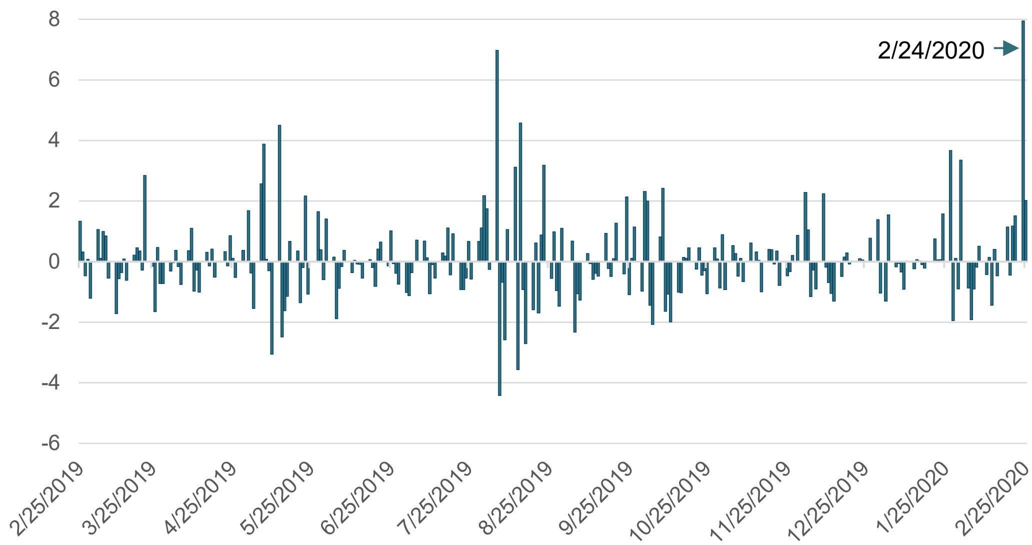
The disruption caused by the virus has already filtered down to earnings. Tech bellwether Apple was the first major U.S. company to announce that it expected to miss revenue projections for the quarter due to the epidemic. The negative impact to Chinese growth has been reasonably anticipated, but the recent news highlighting outbreaks near some of Europe's major financial and manufacturing hubs has ratcheted up uncertainty.

In some regards, the bond market has been reflecting a more concerned state for weeks. The U.S. 3-month/10-year yield curve inverted again on January 31, and the proportion of inverted or flat yield pairs is now greater than 50%.

Headlines have made risks more prominent

Judicious exposure to risk assets was part of the conversation even before the rise of coronavirus cases outside of China. Two key indicators in our work on equity market direction are momentum and volatility. While it's difficult to forecast the progression of a virus, one undeniable result is that market volatility has risen. The CBOE VIX volatility index hit a one-year high at the close of business on Monday, February 24th, and other volatility metrics are similarly inflated.

Exhibit 1: Coronavirus fears drove equity volatility to a one year high – CBOE VIX daily price change



Source: Bloomberg and Columbia Threadneedle Investments. Data as of February 25, 2020

Even if the momentum of the long bull market is still intact, the higher volatility keeps us from being too optimistic about equity market opportunities in the short-term. At the same time, the fall in yields has made an already-negative real yield (nominal U.S. Treasury 5-year yield minus headline CPI) even more negative. In the past, this has been a warning signal that's coincided with instances of market distress.

Expect central banks to be focused on economic data versus market moves in the upcoming months

Facing higher volatility and weaker global growth, we expect to see central bankers bring liquidity to the system globally (via deeper rate cuts, bond buying, etc.). But the important question around central bank action is: *to what end?* Right now, the coronavirus represents a "supply shock" with a rather inelastic supply based in Asia and now Europe (because it's hard to quickly change factory locations). Historically, monetary policy has not had an impact on growth when the impediments are supply driven. But if the economic slowdown related to the virus appears to be morphing into a "demand shock," we expect the Fed to ease more aggressively than current market pricing indicates. We believe that data, such as ISM and industrial production, will be the key driver for the Fed, and we would not expect them to act prior to seeing the numbers. Smart money will see these economic reports as a lagged impact of what has already been priced into the stock market, but headlines featuring shocks to productivity could cause investor sentiment to get much worse.

While exaggerated market response may create opportunities to add to risk, the current environment suggests a heightened level of caution beyond the immediate short-term. Given the uncertainty about containment and the impacts on the global economy, the timeline for "looking through" has likely been extended.

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