WELLINGTON SHIELDS & CO. LLC

Quarterly Market Strategy Report

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CORONA FALLOUT

As news broke of a viral epidemic in China, global markets fell sharply, and analysts struggled to assess the economic fallout. The current statistics of the virus are staggering with over 6,000 cases of the coronavirus found in 17 countries, 132 confirmed deaths, and known cases of human-to-human transmission seen in four countries. China has locked down 15 cities, including the epicenter Wuhan, and is quarantining a population of nearly 60 million people in an attempt to stop the spread of the disease. The US and other nations are screening passengers arriving from China, particularly from Wuhan; while Hong Kong and some Russian provinces intend to close their borders with China entirely. There are five confirmed cases in the US, with an additional 100 people being tested in 26 states. Although the incubation period is still under study, the good news is that scientists and doctors have been able to define the coronavirus genome and believe it is more similar to influenza than SARS. This is very promising since influenza has a substantially lower mortality rate than SARS. Equally important, the 2003 SARS experience has provided a guideline for countries on containment methods and the process needed to develop a testing kit and vaccine.

After a dramatic sell-off in response to the crisis, stock prices rebounded, but investors remain concerned about the longer-term ramifications of this outbreak. The crisis may be too young to quantify, but <u>in our opinion most modern-day epidemics are "economically" similar to natural disasters such as earthquakes, hurricanes and fires. There is a sharp negative economic impact in the short run as normal economic activity grinds to a halt, but the economy tends to rebound and recover what it lost during the crisis in subsequent quarters. And in most all circumstances, the economic trend that was in place prior to the epidemic or disaster, resumes once the crisis abates</u>.

The measures being taken to control the spread of the coronavirus suggest the impact of this crisis will be contained primarily to China and other parts of Asia. However, since China is the second largest economy in the world and is also a major manufacturer and supplier to many industries, the longer the crisis continues the greater the fallout could be on the global supply chain. Nonetheless, the biggest near-term economic impact is expected to be seen in airlines, hotels, casinos and energy stocks due to canceled travel plans. But business and leisure travel should resume once the epidemic is in check. In sum, <u>the epidemic is apt to have a significant impact on China in the first quarter and a more modest impact on the global economy</u>.

EARNINGS ARE CRUCIAL

<u>We believe fourth quarter earnings season could soon overshadow the coronavirus as a market influence</u>. There are 141 S&P 500 companies reporting this week and we expect the impact of the virus will be a major topic on earnings conference calls. To date, 68% of the companies that reported have exceed expectations, but it is earnings guidance regarding the first quarter that will have the biggest impact on earnings growth expectations for 2020. In that regard, this week's earnings report from Apple Inc. (AAPL - $317.69) is quite encouraging. Apple is a high PE growth stock with a large exposure to China in terms of both production and customers. However, not only did Apple's current quarter beat holiday revenue expectations and consensus earnings estimates, but the company announced revenue forecasts for the quarter ending in March that exceeded current analysts' estimates. CEO Tim Cook told reporters that due to the coronavirus the company was using a wider range than normal for its quarterly guidance, but Apple has the flexibility to use suppliers outside of the Wuhan area if necessary and its current revenue estimates include the delayed start of Chinese factories after the Lunar New Year holiday and reduced hours at many of its Chinese stores. This is good news and it bodes well for technology earnings in general for 2020.

Fed on Hold

This week marks the first FOMC meeting of the year and we expect the Federal Reserve will keep interest rates on hold. In large part, the current economy is the perfect combination of "not too hot" and "not too cold." Inflation has been well contained in recent years which means there is no pressure for the Fed to raise rates. The economy is also sufficiently robust that monetary stimulus is not required. However, it is noteworthy that the Fed has been expanding its balance sheet for a number of months. The Fed has stated that this is due to an increase in global demand for US dollars and in order to keep the fed funds rate stable the Fed has had to supply US banks with more liquidity. To do this, the Fed has been buying Treasury bills and short-term Treasuries in the open market and its balance sheet has grown. According to the Fed, this is a temporary change to its longer-term strategy of normalizing its balance sheet. But in terms of the impact on the banking system it is stimulus.

Brexit is Here

This week also includes the formal exit of the UK from the European Union. January 31, 2020 will also mark the start of an 11-month transition period during which the UK will follow all member guidelines while it begins the process of creating new regulations with the EU on trade, security issues, legal rights, data sharing, fishing water rights, aviation standards, electrical and power supplies and the licensing and regulation of medicines. Many are skeptical about the outlook for the British economy after Brexit, but we believe the UK may fare much better than most experts expect. In fact, we believe the UK could begin to rebound now that the uncertainty of Brexit is over, and the country has the ability to control its own economic destiny. If we are correct, this would be a positive for the global economy.

2020 Review

Despite the killing of Iranian Major General Qassem Soleimani, the impeachment of President Donald Trump, the downgrade of global growth forecasts by the International Monetary Fund and the coronavirus outbreak, we see no reason to change our outlook for 2020. Our SPX target of 3300 is unchanged in the near term, but we remind readers that our valuation model allows for the possibility of SPX 3500 later in the year. However, it is has been our view that to move the equity market substantially above SPX 3300 it would require greater earnings confidence and more political clarity. Both could materialize later in the year. Meanwhile, our bullish long-term view is supported by a strong economy that includes record low unemployment, solid wage growth in excess of 3% year-over-year, near record high consumer confidence, strengthening household balance sheets and renewed vigor in the housing market. All these factors will support equity prices in 2020.

From a technical perspective, this pullback appears to be a normal and healthy pause in a bull market cycle. The indices continue to trade above key support levels and the NYSE cumulative advance decline line made a record high on January 17 in line with the record highs in the indices. In short, this suggests that the bull market remains intact and pullbacks represent buying opportunities.

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