WELLS FARGO
Investment Institute

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Last Week's S&P 500 Index: -1.2%

Coronavirus Ups the Ante

Key takeaways

- In light of new coronavirus-related developments, we are making sector changes to increase our preference for sectors high in quality, which we define to be those with low leverage, stable earnings growth, and high profitability.
- We raised our guidance on the Communication Services sector to Favorable (from Neutral) and lowered our guidance on the Industrials sector to Unfavorable (from Neutral).

Efforts to contain the coronavirus, such as travel restrictions, quarantines, and factory closures, have weighed on global equity markets. As of this writing, the S&P 500 is down 7.5% off its February 19 high. Just a few weeks ago, many news outlets were saying that the outbreak had peaked and the worst was behind us. Fast forward to now, and the concern is that the outbreak is just getting started.

The resurgence of concern came after the announcement of increases in cases in Italy, Iran, South Korea, and Japan. Not long after, the U.S. Centers for Disease Control and Prevention informed Americans it is time to prepare for an outbreak closer to home. These headlines were met with 10-year Treasury yields hitting a record low on February 27th, equity market volatility increasing, and further declines in industrial commodity prices.

In light of the new developments, we made sector changes that continue our theme of favoring sectors that generally provide exposure to higher-quality companies[1]. These sectors tend to be more resilient during times of uncertainty due to their characteristically low leverage, stable earnings growth, and high profitability. We recommended to scale back exposure to sectors that are most sensitive to global growth outside of the U.S., where we are now less sure of a V-shaped recovery. To this point, we raised our guidance for Communication Services to Favorable and lowered our guidance for Industrials to Unfavorable.

Industrials have already been struggling due to their reliance on global economic growth, which has been sluggish, and the grounding of a popular airplane from a large U.S. manufacturer, not to mention tariff-related issues. The coronavirus adds to the list of problems as quarantines overseas constrain industrial production.

We recently raised our guidance on Communications Services to Neutral,[1] and the recent developments give us confidence to further increase the sector to Favorable. We believe the Internet and media industry group (80% of the Communication Services sector) revenues should be more resilient against coronavirus impact as much of the content can be consumed at home. Profitability, leverage, and earnings growth characteristics for the past twelve months have been above average when compared to other sectors, which we believe can provide a good source of quality for investors.

These changes reduce our reliance on cyclical drivers of growth in favor of secular trends that we anticipate should help to increase the resilience of portfolios, which has been a call to action since we published our 2020 Outlook.

[1] *Changing 2020 Targets, Guidance, and Allocations,* Wells Fargo Investment Institute, February 26, 2020.

Risks Considerations

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Foreign investing** has additional risks including those associated with currency fluctuation, political and economic instability, and different accounting standards. These risks are heightened in emerging markets.

Sector investing can be more volatile than investments that are broadly diversified over numerous sectors of the economy and will increase a portfolio's vulnerability to any single economic, political, or regulatory development affecting the sector. This can result in greater price volatility. **Communication** services companies are vulnerable to their products and services becoming outdated because of technological advancement and the innovation of competitors. Companies in the communication services sector may also be affected by rapid technology changes; pricing competition, large equipment upgrades, substantial capital requirements and government regulation and approval of products and services. In addition, companies within the industry may invest heavily in research and development which is not guaranteed to lead to successful implementation of the proposed product. There is increased risk investing in the **Industrials** sector. The industries within the sector can be significantly affected by general market and economic conditions, competition, technological innovation, legislation and government regulations, among other things, all of which can significantly affect a portfolio's performance.

Definitions

An index is unmanaged and not available for direct investment.

S&P 500 Index is a market capitalization-weighted index composed of 500 widely held common stocks that is generally considered representative of the US stock market.

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