

STEALTH ASSASSINS

The shots heard around the world; rising fear of coronavirus epidemic

Global equities started 2020 with a strong rally. Investor sentiment got so euphoric that some even floated the idea that economic boom-bust cycles may be over. The killing of Iranian Major General Soleimani in early January turned out to be just a minor speed bump in U.S. stocks' march to new highs. However, something was amiss as U.S. Treasury yields were gradually losing altitude, and there was news out of China about the outbreak of a previously unknown virus in Wuhan -- one of the four major port cities along the Yangtze River. In the early hours of January 23rd, Chinese authorities made the surprise and unprecedented move of locking down this city of 11 million inhabitants in an attempt to contain the coronavirus outbreak. Equities declined in reaction to this exogenous shock, and crude oil, as well as base metal prices, collapsed in unison. On the other hand, safe havens such as gold and U.S. Treasuries rallied, with the latter dragging the 3-month/10-year yield curve back to inversion. By month end, U.S. equities had given up all the gains for the month but still outperformed other regions as our economy was viewed as less exposed to China. This belief of relative safety also lifted the U.S. dollar.

The U.S. real GDP grew 2.1% annualized in the fourth quarter of 2019. While the headline reading looked good, growth in real private final sales to domestic purchasers slowed to a four-year low of 1.4%. Business investment also contracted for three quarters in a row, which is highly unusual during an economic expansion. The tone of the earnings reporting season was mixed, but most companies did manage to meet or exceed expectations. In the coming weeks, investors will have to deal with two developments -- the broadening impact of China's coronavirus crisis, and the start of the U.S. presidential primary season. The former is a fluid situation with a wide range of potential outcomes. The latter will likely drive up market volatility especially if Senator Bernie Sanders, who has been gaining momentum in the polls of late, sweeps the first three races in Iowa, New Hampshire, and Nevada. Judging by the sharp declines in U.S. Treasury yields, the risk/reward for the stock market and the economy appears to be skewed to the downside in the near term.



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EQUITY MARKET INDICES ¹	12/31/19	01/31/20	MTD	YTD
MSCI All Country World	565	559	-1.2%	-1.2%
S&P 500	3231	3226	-0.2%	-0.2%
MSCI EAFE	2037	1994	-2.1%	-2.1%
Russell 2000	1668	1614	-3.3%	-3.3%
NASDAQ	8973	9151	2.0%	2.0%
TOPIX	1721	1684	-2.1%	-2.1%
KOSPI	2198	2119	-3.6%	-3.6%
Emerging Markets	1115	1062	-4.7%	-4.7%
Fixed Income				
2-Year US Treasury Note	1.57%	1.32%	-26	-26
10-Year US Treasury Note	1.92%	1.51%	-41	-41
BarCap US Agg Corp Sprd	0.93%	1.02%	9	9
BarCap US Corp HY Sprd	3.36%	3.90%	54	54
USD Performance				
Chinese Renminbi (CNY/\$)	6.96	6.94	-0.3%	-0.3%
Brazil Real (Real/\$)	4.03	4.28	6.3%	6.3%
British Pound (\$/GBP)	1.33	1.32	0.4%	0.4%
Euro (\$/EUR)	1.12	1.11	1.1%	1.1%
Japanese Yen (Yen/\$)	108.61	108.35	-0.2%	-0.2%
Korean Won (KRW/\$)	1156.25	1191.70	3.1%	3.1%
US Dollar Index (DXY)	96.39	97.39	1.0%	1.0%
Commodities				
Gold	1517	1589	4.7%	4.7%
Oil	61.1	51.6	-15.6%	-15.6%
Natural Gas, Henry Hub	2.19	1.84	-15.9%	-15.9%
Copper (cents/lb)	280	252	-10.0%	-10.0%
CRB Index	186	170	-8.3%	-8.3%
Baltic Dry Index	1090	487	-55.3%	-55.3%

Source: Bloomberg.

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THE ORDER OF ASSASSINS

Between the 11th and 13th century, the Order of Assassins, which operated from the mountains in Persia and Syria, was a much-feared secret society credited with the assassinations of two caliphs and many sultans, viziers, and Crusader leaders. It was founded by Hassan-i Sabbāh, a Nizari Ismailism missionary (a branch of Shia Islam) who converted people in the Alborz mountain range south of the Caspian Sea. Hassan and his followers later seized a mountain top fortress in Alamut, located roughly 150 miles northeast of today's Tehran, as the base from where he directed the expansion of the sect's influence and terror. The Alamut Castle also earned Hassan the "Old Man of the Mountain" moniker.

Hassan's assassins were known for their secrecy and fearlessness. An assassin could infiltrate a target's inner circle and lay dormant for years, then conduct the killing in public with a dagger into the target's chest to maximize the shock effect. Hassan was also a master of psychological warfare. A sultan who refused a peace deal from Hassan woke up one morning with a dagger stuck in the ground next to his bed. After he was informed by Hassan's messenger that the dagger could have been planted in his chest, the sultan accepted Hassan's deal and paid a tribute to Alamut for decades.

Hassan won over his assassins' loyalty and devotion with a combination of hashish and the promise of a blissful afterlife. Indeed, the crusaders derived the word "assassin" from "hashashin" in Arabic, which means "hashish user." Hassan made his devotees believe that the ecstatic state they experienced under the influence of hashish was a vision of paradise only accessible by following his orders. One story had Hassan-i Sabbāh placing the decapitated head of an assassin at the foot of his throne, using his 'special power' he commanded it to speak about paradise. It was of course set up with a loyal lackey buried up to his neck and covered with blood. The "talking head" would assure Hassan's followers that there is a place in paradise for them if they truly dedicate themselves to Hassan. Unfortunately for this loyal lackey, Hassan killed him afterward and displayed his head on a stake in order to cement the deception.

The Order finally met its match among the invading Mongols in the 1250s. Genghis Khan's grandson, Möngke Khan, decided to eradicate the Order after its assassins failed to take him out. Mongol warriors scaled the Alamut's steep escarpments and surprised the fortress' defenders, forcing the Grand Master of the sect to surrender. Mongols lavished him with gifts and debauchery, and took him to other Ismaili strongholds to order his followers to give in. After all the Ismaili fortresses were conquered, the Mongols unceremoniously disposed of him.

THE SHOTS HEARD AROUND THE WORLD

At 12:32 am on January 3rd, a Cham Wings Airlines' A320 aircraft from Damascus landed at the Baghdad International Airport. Qassem Soleimani, the 62-year-old commander of Iran's Quds Force, stepped off the stairs to the tarmac and was greeted by Abu Mahdi al-Muhandis, the head of Iran-backed Shia militia Kata'ib Hezbollah. The two got into a waiting SUV and sped away in the dark of the night, followed by their bodyguards in a second vehicle. Unbeknownst to them, an American MQ-9 Reaper drone was hovering nearby. As Soleimani's two-car convoy turned to the perimeter of the airport, two missiles were fired from the drone and smacked into the first car. The bodyguards in the second car could barely react before a third missile slammed into their SUV. Just like that, the most feared and powerful Iranian general who had fashioned himself after Hassan-i Sabbāh, for the practice of asymmetric warfare and terrorism, was reduced to pieces in a smoldering car wreck.

The initial reaction around the globe was one of apprehension – stocks sold off while prices of crude oil and gold soared. WWII memes started trending on social media and Iran's Supreme Leader Ali Khamenei vowed "severe revenge." President Trump tweeted that the U.S. would target 52 Iranian sites if Tehran dares to retaliate. Behind the scenes, however, the two governments started exchanging less confrontational back channel messages via the Swiss Embassy in Tehran in a mutual effort to diffuse the tension.

In the wee hours of January 8th, Iran fired more than a dozen missiles at two U.S. military bases in Iraq. In a move reminiscent of Baghdad Bob's bluster in 2003, Iran's Mehr News Agency boasted that at least 80 U.S. soldiers were killed and some 200 others were injured. Iran's Foreign Minister Javad Zarif subsequently stated that this had concluded Iran's retaliation, and the country would not "seek escalation or war." It was a face-saving gesture from the mullahs who may have been caught off guard by President Trump's deadly move. The bad actors in the region may be wondering if they will be in the crosshairs of the next U.S. drone strike. Ironically, Trump may have become the feared Old Man of the Mountain to them.

CRUDE CALCULATIONS

Crude oil prices had initially surged in reaction to the attack on Saudi oil facilities last September and the killing of Soleimani. However, these rallies have quickly fizzled out in the absence of further escalation of tension. Investors have not baked in much geopolitical risk premium in crude oil prices. It is also a reflection of the market's bearish view on crude oil's long-term outlook.

As a case in point, when the spot price of WTI crude oil spiked 15% to \$69 per barrel last September, the forward price for January 2023 rose by only 3% to \$52, and the long-term price expectation edged up to just \$54 for 2030. Five years ago, when the oil market was in a severe downturn, the expected oil price for January 2023 was over \$70 a barrel, substantially above the then-spot price of \$48. Ten years ago, the forward curve had projected rising long-term prices approaching \$100 a barrel.

The market's cautious view on crude oil is underpinned by several developments. America's shale energy revolution, which has increased U.S. daily crude production from 5.5 million barrels at the start of 2010 to 13 million in early 2020, has been a game changer for oil supply. On the demand side, climate change-induced natural disasters will likely accelerate the migration away from fossil fuels. Indeed, the concept of stranded assets has been gaining traction in recent years. It postulates that, in order to cap global warming at 2°C or lower in the coming decades, fossil fuel consumption and production must be materially curtailed, which would leave a large portion of existing fossil fuel reserves untapped. A study in 2015 estimated that roughly a third of oil reserves, half of natural gas reserves, and more than 80% of coal reserves will need to be kept underground in order to sufficiently slow down the buildup of carbon dioxide emitted into the atmosphere. While energy producers are unlikely to curtail capital spending and future production out of concern for the environment, lower expected oil prices will make some projects financially untenable. It also remains to be seen if OPEC members, upon realizing that some of their fossil fuel reserves will be stranded in the long run, will elect to maximize their output rather than hold back production to temporarily prop up prices. These concerns have pushed U.S. energy stocks' relative price-to-book ratio to the lowest levels in 90 years, and the energy sector's weight has fallen from over 13% of the S&P 500 Index in 2008 to just a bit over 4% today, the lowest in four decades.

While the outlook for energy stocks and crude oil prices appears questionable for the long haul, it could still surprise on the upside in the short run. The decline in active oil rigs in the U.S. from 2019's high of 877 to 675 at the end of January 2020 could lead to tighter U.S. supply later in the year. Geopolitically, Iran's avoidance of direct confrontation with the U.S. in the wake of Soleimani's death does not mean that it will give up its Shia Crescent ambitions in the region. In time, Iran will likely launch more attacks through its proxies, similar to what the late Colonel Gaddafi of Libya did in the 1980s. In April 1986, the U.S. bombed Gaddafi's residence and other targets in retaliation for a string of Libyan backed terrorist attacks. Some thought the air raid may serve as an effective deterrent against future terrorist acts since Gaddafi had just narrowly escaped death. Yet five months later, Gaddafi ordered the hijacking of Pan Am Flight 73 in Pakistan, which led to 20 deaths. In December 1988, Libyan agents perpetrated the horrific bombing of Pan Am Flight 103 over the sky of Lockerbie.

The killing of Soleimani may also harden Iran's resolve to develop the nuclear bomb. It's not lost on Iran's mullahs that Trump and Kim Jong Un have been exchanging "beautiful letters" and mutual admiration solely because of the chubby marshal's nuclear arsenal. It's unclear how this thorny issue gets resolved, and if the embattled Israeli Prime Minister Netanyahu might feel compelled to launch an attack on Iran's nuclear facilities. In short, the region remains a tinderbox.

THE SIEGE OF WUHAN

While the world's attention was focused on Iran and the U.S. in early January, Chinese health officials were investigating the cause of a pneumonia outbreak in Wuhan. Rumors were circulating that it was similar to the SARS epidemic of 2003, but the government had initially refrained from warning the public for fear of triggering panic. However, as the coronavirus infection spread overseas and human-to-human transmission was confirmed, China quickly went into damage control mode and took the unprecedented step of quarantining Wuhan and neighboring cities covering more than 60 million people. Numerous Chinese cities also shut down public spaces, closed off inbound traffic, and have advised residents to stay home for 14 days to get past the disease's estimated incubation period. It's clear that China was determined to take the short-term economic pain to avert potentially greater disasters.

With the Chinese economy now ranking second in the world at roughly two-thirds the size of the U.S., the economic toll from clamping down discretionary activities in much of the country will reverberate far beyond its borders. Global supply chains will also be disrupted by extended factory closures and logistical challenges. The previously anticipated rebound in global manufacturing activity is now pushed further out, and there will be negative economic and earnings growth revisions in the coming months. In the absence of concrete data on the 2019-nCoV virus' transmissibility and severity, there is a wide range of potential outcomes. Various reports of infected individuals becoming contagious before the onset of the symptoms indicate that it could be challenging to contain the outbreak. There is also the risk of the virus mutating into something more deadly. On the positive side, doctors in Thailand have shown that a combination of HIV and anti-flu medicines was effective in treating several infected individuals. While one cannot rule out the tail risk a global pandemic, our base assumption is that the health crisis will blow over in a span of months, similar to the SARS outbreak in 2003. China will also inject both fiscal and monetary stimuli to assuage the economic damage. In time, some of the disruptions created by this crisis will turn into investment opportunities. That said, markets will likely experience higher volatility in the near term, and the antidote to elevated economic and market risks remains a diversified portfolio.

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