AA View

Viral volatility – Market actions and reactions

Summary

- The virus scare is now unfolding in a sequential way from China, Korea and Italy globally. These three are important players in the global economy but the globalisation of the scare and its wider impact is the larger concern.
- Spiking market volatility has so far been the biggest impact of the coronavirus scare to date. Actual market falls have not been large, and valuation improvements are so far looking quite modest.
- The big fall in US bond yields is particularly eye-catching, now validated by the US Federal Reserve's emergency rate cuts. With more rate cuts still to come – US and elsewhere - yields everywhere could move still lower near-term. Conviction on any marked yield reversion is low.
- With such large uncertainties on the Coronavirus, an agnostic rather than a definitive view on its lasting market impacts seems appropriate.
- This is not a buying opportunity at current equity market levels though high volatility and renewed market falls may allow for some rebalancing.

Economic and market actions so far

- *The Coronavirus scare is unfolding in what epidemiologists have correctly predicted to be a sequential global move outwards from China, Korea and Italy. The scare's global reach and intensity is bound to worsen for at least some time.* The scare and the attempts to contain spread is the primary source of economic disruption globally. The China disruption to economic activity has eased at the margin, with a partial return to work, but indicators of the 'resumption to work' momentum in China are only improving slowly. Though a lot better than two weeks ago, on a country-wide basis these still appear at well under 50% at the start of March. The bigger current concern is with Korea and Italy where virus spread acceleration on a reported basis is ongoing. China, Italy and South Korea together come close to accounting for a fifth of global GDP and are sizable players in many industrial sectors, so significant disruption to their domestic economies matters for the global economy. This is before allowing for the potentially far larger effects from the virus scare constraining activity in the US, Europe and Asia-Pacific regions. A fear of enclosed spaces is now clearly on the rise among populations in many countries, and this is not selective in sectoral impact. The 'supply-side' impacts in interrupting production and delivery cycles are coming from disruption to complex chains where the impact is only now being felt.

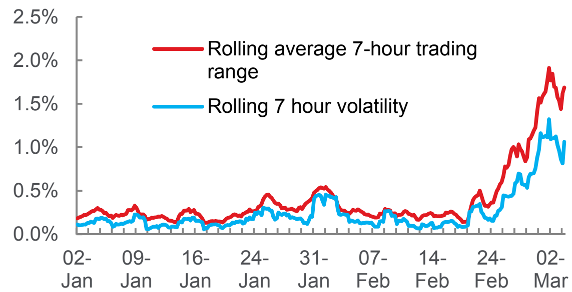
- *The virus scare has come at a bad time for the global economy*. The rapid deterioration in global activity stemming from trade conflict and weakness in global manufacturing seemed to be easing in late 2019, but this has resumed from mid-February. To repeat the message from our last note on the Coronavirus[1], this is not a great starting place for a further shock to global economic activity.

- *Equity and credit valuations were very high before the Corona panic. The picture is a bit better now, but not markedly so*. Equities (MSCI All Country World Index) were down about 10% at its worst point from when the trouble began on the 19th February, but have seen two powerful countertrend rallies, the last prompted by better than expected market news from the US Democratic primaries. Valuation improvements have been modest. US market valuation ratios like forward Price to Earnings, Price to Sales, or Price to Cash Flow have moved from the very top of their two-decade ranges to somewhere averaging the 80th percentile. The snag is that downward revisions to company profits have only just begun. Once this is allowed for, the reversion in valuations looks small. It looks similar in credit, where the 30bps and 125bps rise in US investment grade and high yield spreads, while at better levels than before the Corona news, is not enough of a move to argue that value has returned. It is notable that across equities and credit, the Corona moves look roughly half the magnitude of Q4 2018; this was the time when the Fed rate rise scare had set volatility alight. Then, equities were down almost 20% and investment grade and high yield bond spreads rose 50bps and 240bps, respectively. The Corona scare moves to date are not large, therefore, even against recent experience.

- *An important part of the market action has been in government bond markets*. During this period of turmoil, US treasury bond yields have fallen furthest, which is no surprise since they were still at levels from which larger falls were possible, unlike Europe, Japan and the UK where yields were already either close to zero or below. Thanks to an expectation that the US Federal Reserve would cut interest rates aggressively, duly met this week when the Fed cut rates ahead of its interest rate-setting meeting, the move in yields has been one of the most eye-catching features of the Corona scare. The 60bps fall in 10-year US treasury yields, now at below 1% yields at the time of writing, all in a little over a week, has been remarkable. It has also occurred as an unbroken straight line, yields falling even on the days when equities were bouncing.

- *Though the market moves were not large, the speed of the initial decline in equities on the viral scare (week of 28 February) was strong.* We need to go back to 2008 to see an equivalent sized move to this one. The reason is that long positions had been building through January and February by asset managers and other market players in both discretionary and systematic funds, and their hurried liquidations strengthened the downtrend. This prompted an explosive move in volatility. Moves were stronger than in late 2018. The VIX index recently went above 40 briefly, higher than in Q4 2018. You can also see this by looking at trading or intra-day volatility which has become intense – shown in the trading range for the US market as well as the rolling volatility which exploded upwards (see chart).

Volatility explodes in the S&P 500 index



Source: Bloomberg

The 'don't knows' on Corona – severity or duration

- *There is no real understanding or insight on how bad the virus transmission will be, or when containment might (if we are lucky) occur*. This is partly because we do not know the true number of those infected – if the detection rate is only averaging 5-10% as some epidemiologists in this area claim, the current global total cases approaching 100,000 on a reported basis, could be much, much higher. If this is so, the transmission potential is equivalently much larger. It is good news from the viewpoint of a lower ultimate mortality rate from the virus than currently assumed, but far less good from every other perspective.

- *Working in the dark in this way, it is more prudent to regard further reported case-escalation as an inevitability*. From an economic perspective, what will matter is that the news-flow on infections will likely continue to signal more cases, possibly at an accelerating rate for those countries at an earlier stage of the infection like non-Italian Europe or the US. This will keep the scare level high. Even then, the detection rates will probably still very substantially understate cases. What will matter for markets is the overall disruption to normal economic activity. We should expect the scare and its impact to worsen for most of the 2nd quarter. Thereafter, it is really the great unknown. Major global public health initiatives on containment may come forth, but short of a Hubei-style shutdown in vast chunks of the global economy, it may be tough to argue the case for quick success.

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[1] *A Move Towards Panic,* AA Views 26 February

Reactions – what is to be done?

Is this a buying opportunity in equities?

One reasonable reaction is to say that viruses 'come and go'. If this had been a playout like previous virus scares like SARS, the correct reaction would of course be to look at market weakness as a buying opportunity because the scare would subside in the next few weeks. With the Federal Reserve having cut interest rates 0.5% already, and with more to come, with liquidity boosts and rate cuts again spreading elsewhere like wildfire and now the promise of IMF assistance for poorer countries afflicted by the virus as well, you could argue that a market backstop is being formed, as policymakers bend over backwards to cushion the viral impact on economic activity. On this basis, the case for seeing current and prospective market falls as a buying opportunity would appear on the face of it to be good.

Yet, things are not quite so simple. There are at least three reasons why this may not be a buying opportunity in equities other than for some special situations.

- *First, this is a global scare, not confined to one country or even one region of the world and its spreading potential or 'transmissibility' is high*. Viruses do indeed come and go, but their reach, impact and duration can vary wildly. Corona's potential to be spread asymptomatically carries the big risk of escalation, and it is this that is causing the fear of public places and ad hoc attempts to contain the virus, like school closures. This creates far more uncertainty on containment measures and whether and when they might work. The Corona scare should not be taken to imply a high recession risk in and of itself, though it certainly has the potential to do so in bad transmission scenarios given the already weak wider economic backdrop. Given the heavy dose of uncertainty, we see this as implying taking an agnostic view on the risks rather than any definitive good or bad view on how long and how severe the ultimate economic impacts will be.

- *Second, as already noted above, market falls and improved valuations on the Corona scare still appear minor relative to the risks and uncertainties*. With sustainable return potential (especially risk-adjusted) from equities having diminished substantially before the Corona scare set in, the plain fact is that the fall in equities is nowhere near to being enough, yet, to tip the scales in favour of a significant change of view and towards seeing this as a buying opportunity. Since the background causes for the earlier weakness of the global economy that have stemmed from trade conflicts and economic policy uncertainty are not going away (as we have noted, trade conflicts appear to be an ongoing part of the global economy) the case for taking a much more positive stance on equities and credit at this stage weakens.

- *Third, while interest rate cuts and liquidity support from central banks can achieve some cushioning impact, as we have noted before, they deliver less for economies if rates are already low to start with.* This was the case with the US before this week's interest rate cuts. Europe and Japan can only move minimally in this direction anyway. Rate cuts do not do much to cushion the real economic and corporate cash flow impacts from weaker activity, though direct help to cash-strapped corporates, if this can be implemented, may at the margin support some companies through the disruption (though this is far more likely to be directed at SME's rather than quoted companies). This is not to underplay the liquidity impulse in markets that the Federal Reserve is delivering, and we saw how much this can matter from the way this drove risk-asset prices substantially higher in Q4 2019. However, its market-boosting impact is now looking much smaller even without the virus news playing at the back. The point of maximum positive impact from interest rate cuts on economies and markets is now well behind us, even in the US. There is a risk now, that instead, the market perceives rate cuts from existing low levels to be a sign of central bank weakness in the face of this developing pandemic, given the limited ammunition left to fight economic weakness. Support from the central bank 'put' to markets, so important for so long, is now smaller even if it may not have disappeared entirely.

- *For diversified portfolios running significant underweights to equity allocation targets, a case can be made for partial rebalancing.* High volatility and the possibility of further market falls could be opening a window for this activity.

Reactions to lower bond yields?

- *Much the same viral uncertainties apply to bonds.* The last Coronavirus note described the likelihood of yields going still lower, and they have, but even at today's levels, they remain more likely to go down than up on the basis that the scare will worsen near-term. If Corona is not contained, recession risks could keep yields at new, still lower, levels for quite some time. Yes, if the virus is contained, yields should bounce, but it still looks unlikely that even this kind of positive development will do much to bring any sustained upward trend in yields back into the market. These uncertainties need to be kept front of mind. The lack of any conviction on when and by how much yields eventually revert higher suggests that defensive and liability-matching hedging activity keeps its portfolio role and importance very high.

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