DELPHI DIGITAL

# The "Inflection Point"

March 2020

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# Key Takeaways

Trying to keep up with markets the last two weeks has been nothing short of exhausting. Volatility spikes, false rallies, and a whole lot of red on the screen just about sums up the price action we've seen since markets began their cascade lower. Recent price action suggests **market participants have finally woken up to the potential severity of the coronavirus threat** with this weekend's oil market drama only adding more fuel to the dumpster fire. After fending off the rising tide of uncertainty for weeks, **risk assets finally caved under a mountain of pessimism.** The most important question now is, well, what's next? While the size and scope of the coronavirus outbreak is far from known, in my view there are most likely two paths going forward: either the market is still severely underestimating the long-term impact of COVID-19, in which case asset prices have further to fall, or the economic impact will prove to be less damaging than market participants expect and the latest correction will turn out to be a ripe buying opportunity. Below are some of the most significant market trends we're following so far as the fallout unfolds:

- The uncertainty surrounding coronavirus coupled with the latest collapse in oil prices is causing a significant repricing of risk, accelerating selling pressure on riskier assets vulnerable to a cyclical slowdown or economic contraction.
- Long-dated Treasuries are up a stunning **20-25% year-to-date,** pushing the asset class to its **most overbought level in at least 15 years** and the **yield on 10-Year U.S. Treasury bonds to its lowest on record** (currently 0.5%). Gold and bitcoin have both gained roughly 10% since the start of the year.
- The **S&P 500 plummeted over 7% today** (March 9th), **marking its worst daily decline since 2008.** The last couple weeks have been beyond rough for the large-cap U.S. benchmark, which is now **trading more than 18% below its February peak.**
- Markets expect the Fed to cut rates at least **another 50 bps at the March FOMC meeting next week.** More telling, however, is the fact there's now a **40% chance the Fed cuts rates to zero by the end of the year.**
- The surge in market volatility and collapse in oil prices has already caused financial conditions to tighten. Energy companies constitute a considerable proportion of the U.S. high yield debt market, so if credit conditions tighten, the ripple effects will be felt across markets far beyond just the oil industry.

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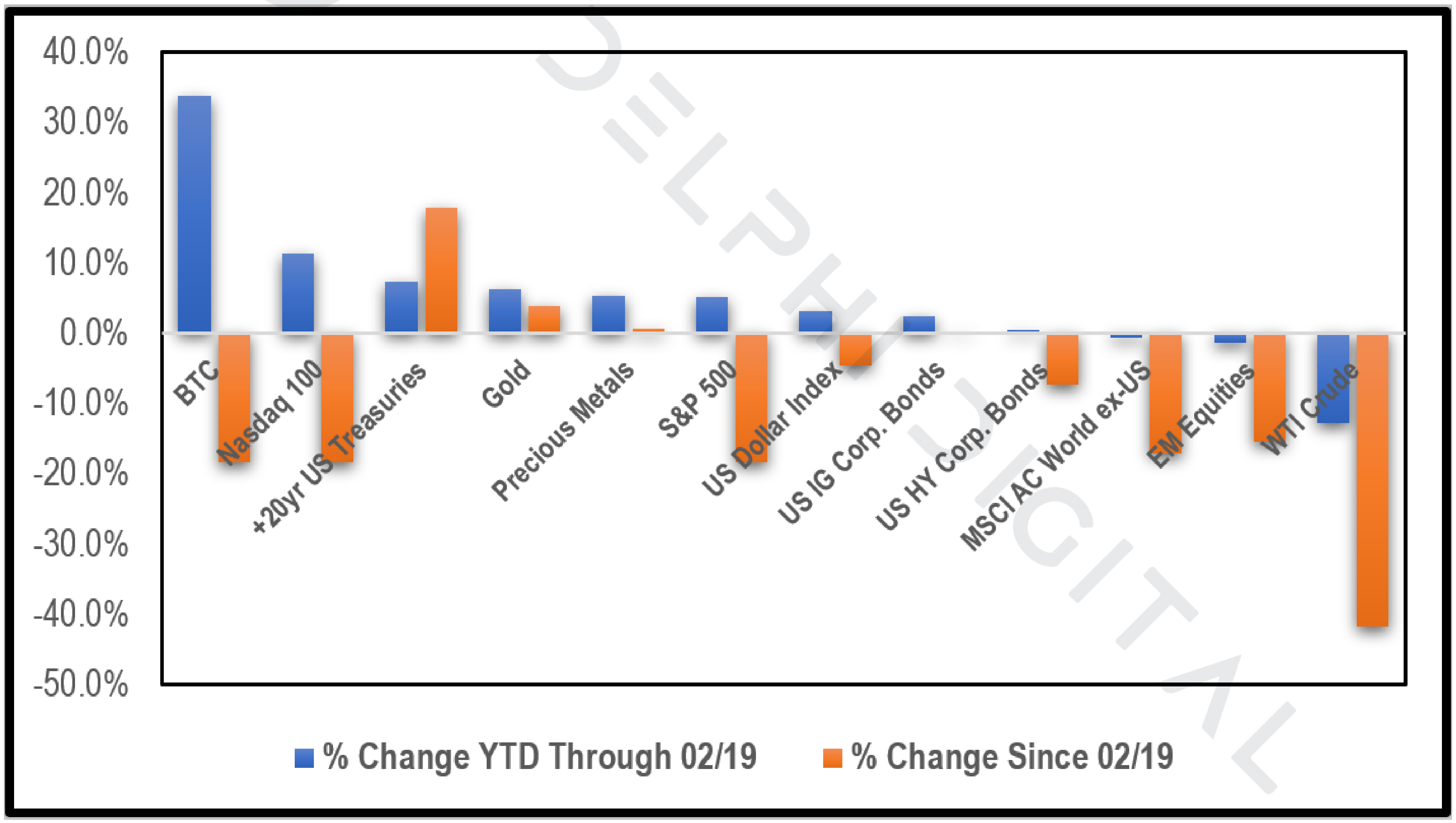
# Market Meltdown

We are in the midst of a major correction spanning multiple markets and asset classes. The uncertainty surrounding coronavirus coupled with the latest collapse in oil prices is causing a **significant repricing of risk, accelerating selling pressure on riskier assets vulnerable to a cyclical slowdown or economic contraction.** The swiftness of the correction has many investors scrambling to sell anything with liquidity as they cover positions and prepare for the worst. That is why, in our view, other safe haven assets like gold have not performed as well as one might expect in a similar risk-off environment; **U.S. Treasuries still reign king when it comes to a mass flight-to-safety move.** Long-dated Treasuries are up a stunning **20-25% year-to-date** while gold and bitcoin have both gained roughly 10% since the start of the year. The **S&P 500 is down 15%** over the same period while the **price of crude oil has nearly been cut in half.**

*Major Asset Class Performance*




*Data as of March 9th, 2020*

*Source: Digital Assets Data, Nasdaq, S&P Dow Jones, BlackRock, Vanguard*

# Tale of Two Narratives

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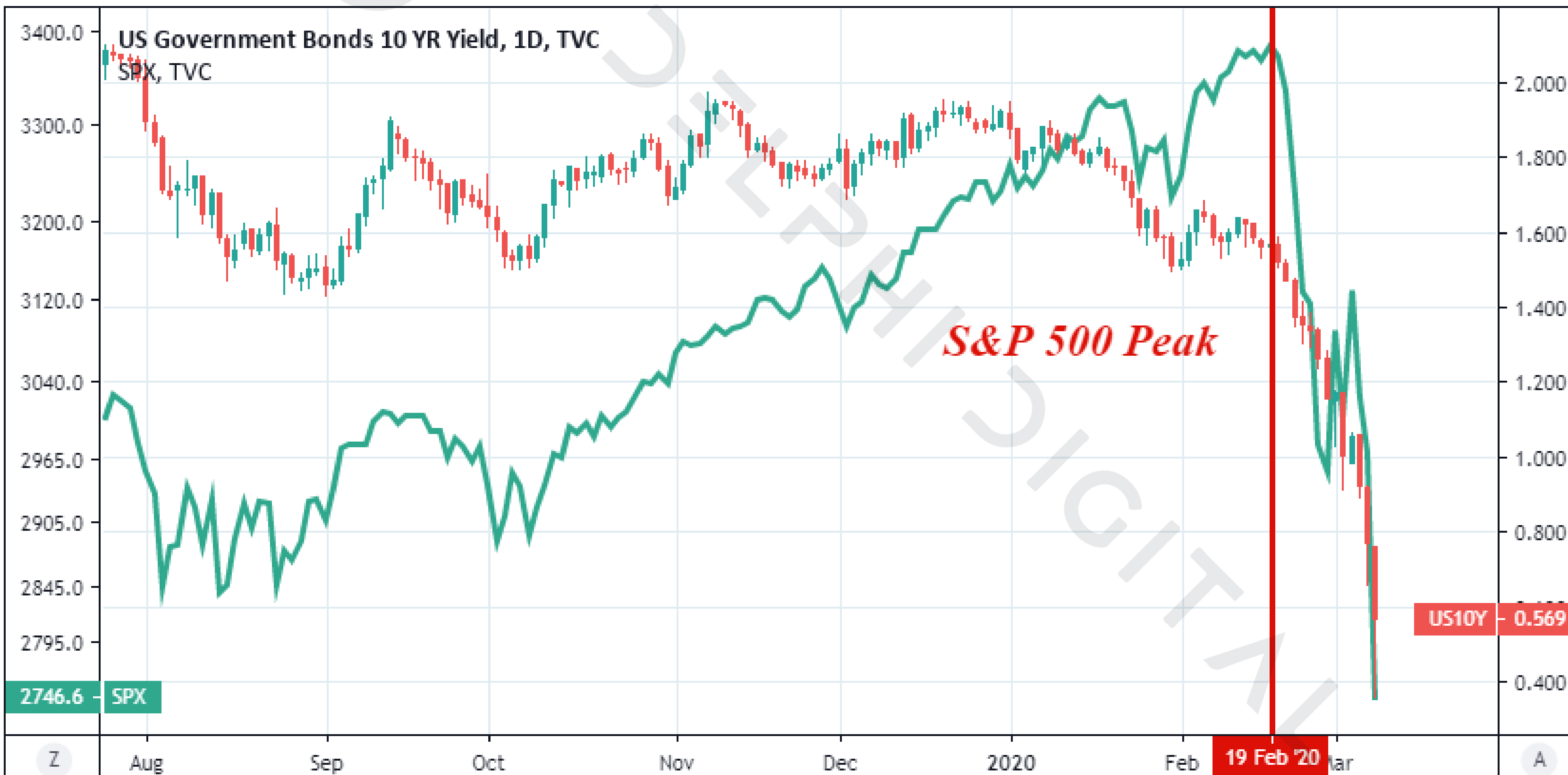
This year has been a **battle of two opposing narratives centered around the long-term impact of the coronavirus outbreak.** On one hand, equity markets appeared to be pricing in a much more optimistic base case up until about two weeks ago. Conversely, the bond market – notably U.S. Treasuries – were painting a far bleaker picture, one that market consensus seems to be unifying around with each passing day. Since the stock market's peak on February 19th, the situation has become flat out ugly for anyone who wasn't 100% allocated to Treasuries heading into this recent bloodbath. Treasuries are still regarded as one of the safest investments available, which is one of the key reasons we've seen yields on U.S. government bonds plunge over the last couple weeks. At the same time, growth and inflation expectations are falling amid all the uncertainty, depressing yields on longer-dated Treasuries further.

*10-Year U.S. Treasury Yield vs. S&P 500 (Green)*




*Data as of March 9th, 2020*

*Source: TradingView*

# Record Drawdown for U.S. Stocks

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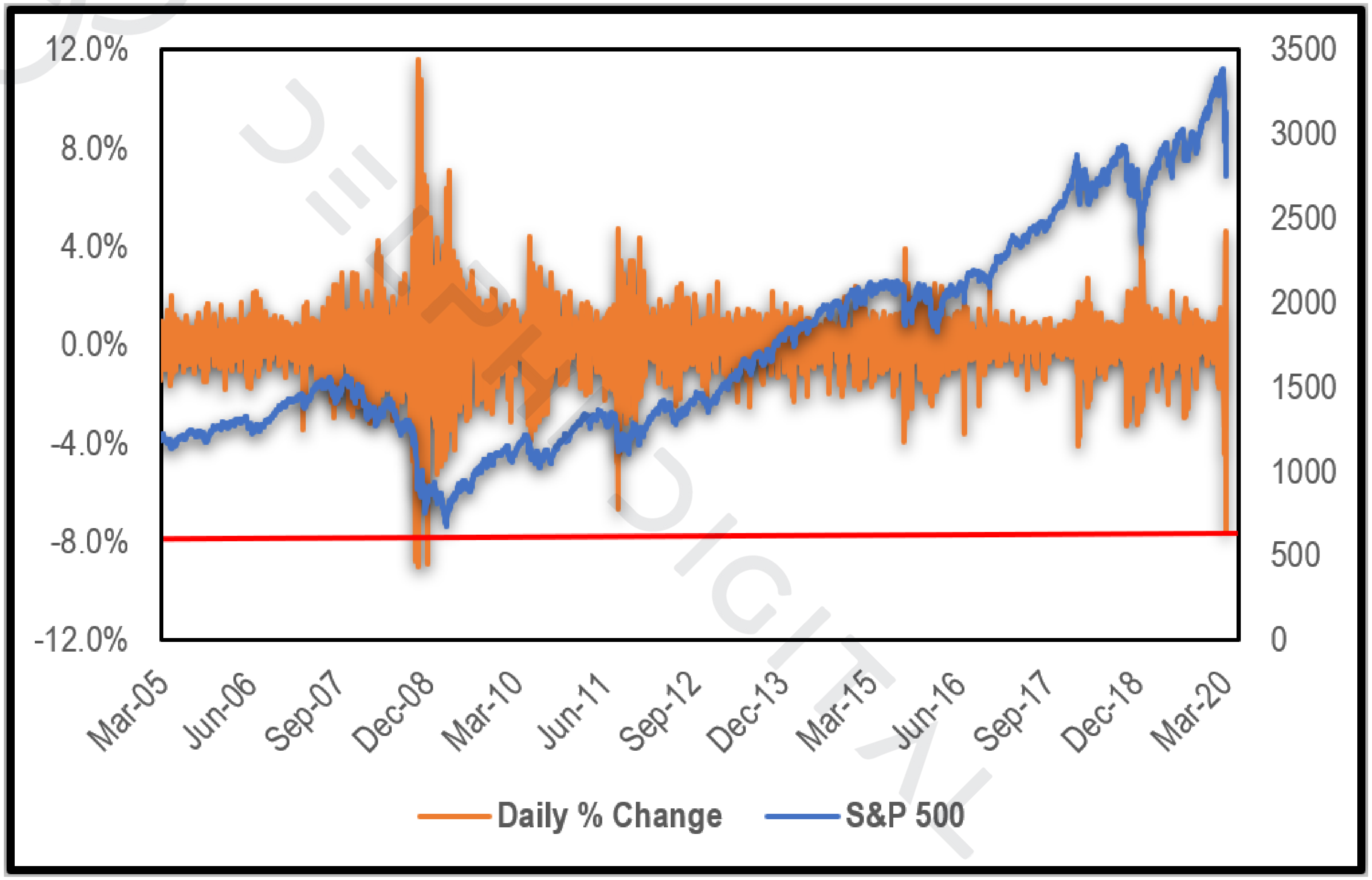
It's often joked that the stock market takes the escalator up and the elevator down. Judging by the equity market's latest plunge, it's safe to say the old adage still holds true. In fact, following its February 19th peak, the **S&P 500 experienced its fastest 10% correction from an all-time high in more than 70 years.** And things haven't gotten any better since then; the **S&P 500 plummeted over 7% today** (March 9th), marking its **worst daily decline since 2008.** The last couple weeks have been beyond rough for the large-cap U.S. benchmark, which is now **trading more than 18% below its February peak,** just above the infamous 20% drawdown often regarded as the official "correction" threshold.

Barring a resurgence in optimism and a major reversal, the decade long bull run in stocks seems to be under serious threat.

However, it's important to note the S&P 500 has experienced considerable drawdowns throughout this cycle, most recently in **Q4 2018 when the index fell 19.8% from its October high.**

The difference between a 19% correction and a 20% correction is more psychological than anything, but that's not to say the current drawdown should be dismissed.

*S&P 500 vs. Daily % Change*

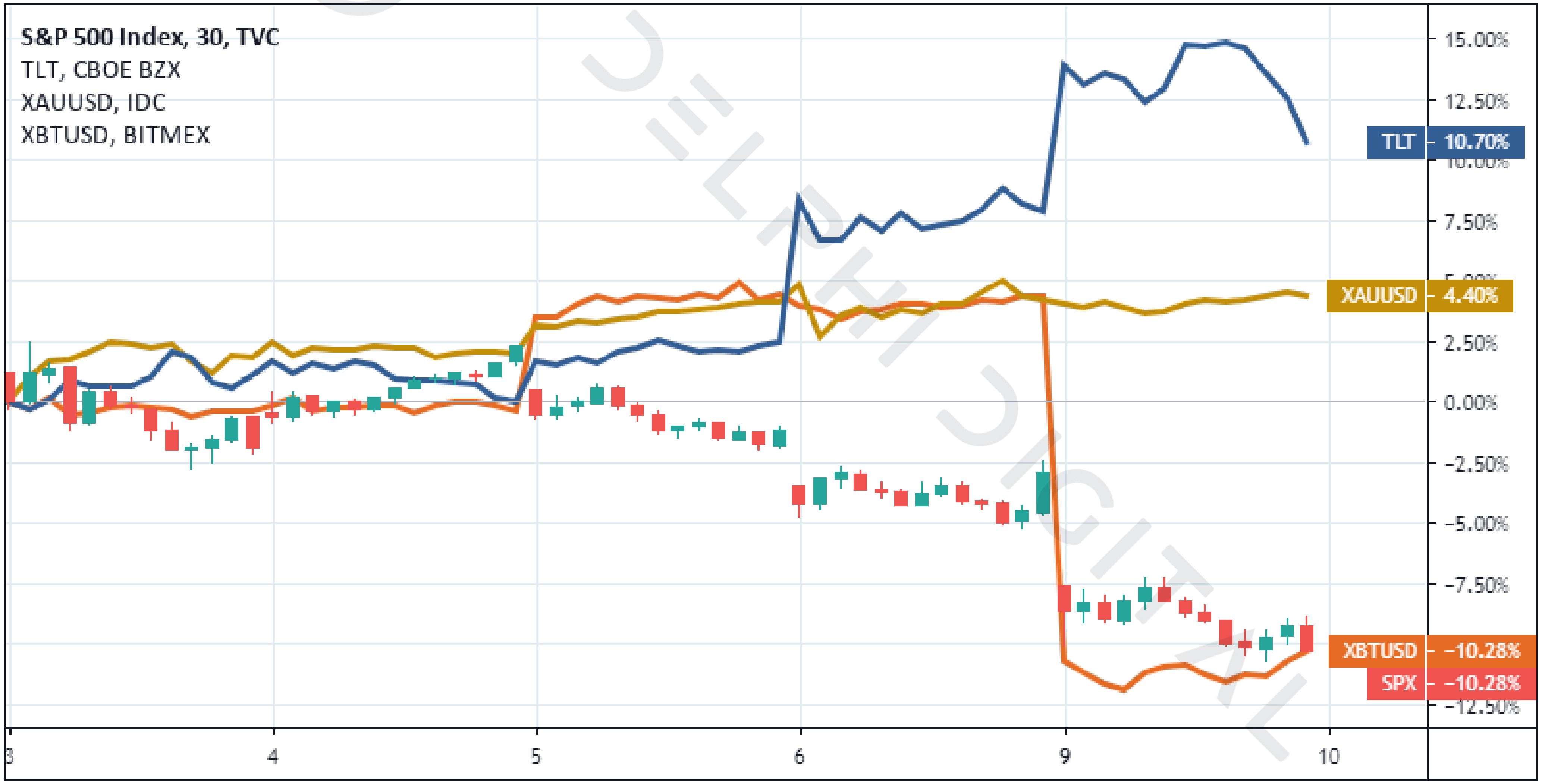



*Data as of March 9th, 2020*
*Source: Bloomberg*

# Stocks on Shaky Ground

The equity market faces a tremendous amount of risk - even at these levels – if a recession truly lies ahead. If the economy contracts, earnings will follow suit, which does not bode well for stock prices. **A broad repricing of risk would put greater pressure on valuation multiples, which will hammer prices even more.** The equity market's ability to sustain current levels depends on the outlook for earnings growth going forward; if the adverse effects of the public's response to coronavirus start to dent corporate profitability, the pain in equities is likely to get worse before it gets better. Sentiment has certainly shifted in recent weeks, evident in the market's tepid reaction to the Fed's rate cut, which **did more to confirm the gravity of the situation unfolding rather than reassure investors everything was under control.**

*S&P 500, LT Treasuries, Gold, & BTC Since Fed Emergency Rate Cut*



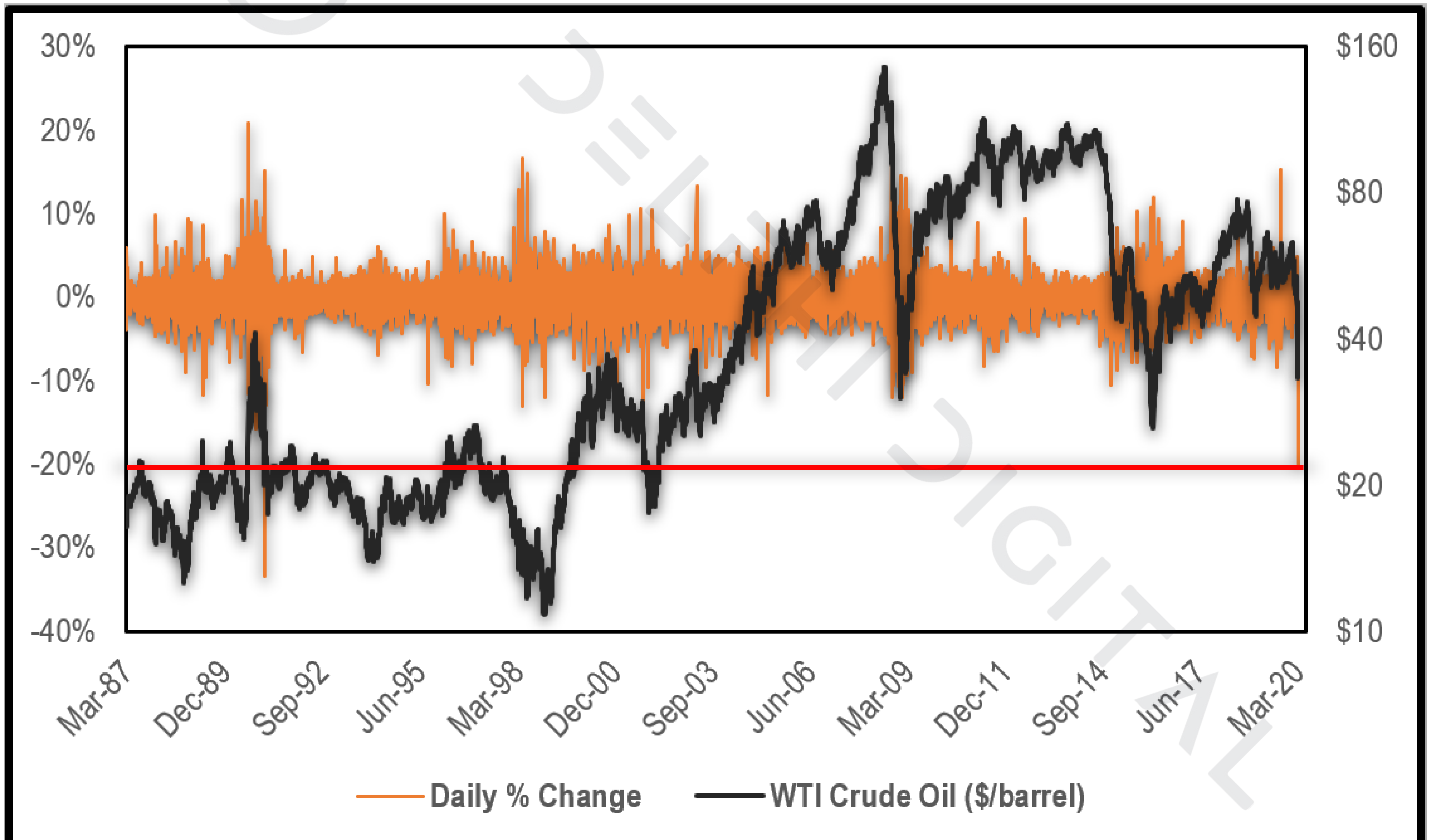

*Data as of March 9th, 2020*
*Source: TradingView, BitMEX, Cboe*

# Crude Craters as Volatility Strikes



The latest bout of selling pressure stems from the drama unfolding in the global oil market, which now faces one of its biggest threats in the last decade. News broke over the weekend that Saudi Arabia, the second largest oil producer in the world and prominent member of the Organization of the Petroleum Exporting Countries (OPEC), is planning to **ramp up production** after Russia rejected a deal to cut its own production in the face of weakening demand. Russia's defiance caused the Saudi's to do a full 180 degree pivot, sparking a full-blown price war at a time when **demand for crude is under serious pressure** from the coronavirus outbreak. The price of **WTI crude oil crashed nearly 25% on Monday - its worst one day decline in almost 30 years** - briefly touching $30/barrel for the first time since February 2016.

*WTI Crude Oil ($/barrel) vs. Daily % Change*




*Data as of March 9th, 2020*
*Source: TradingView*

# Downstream Effects of Oil Shock

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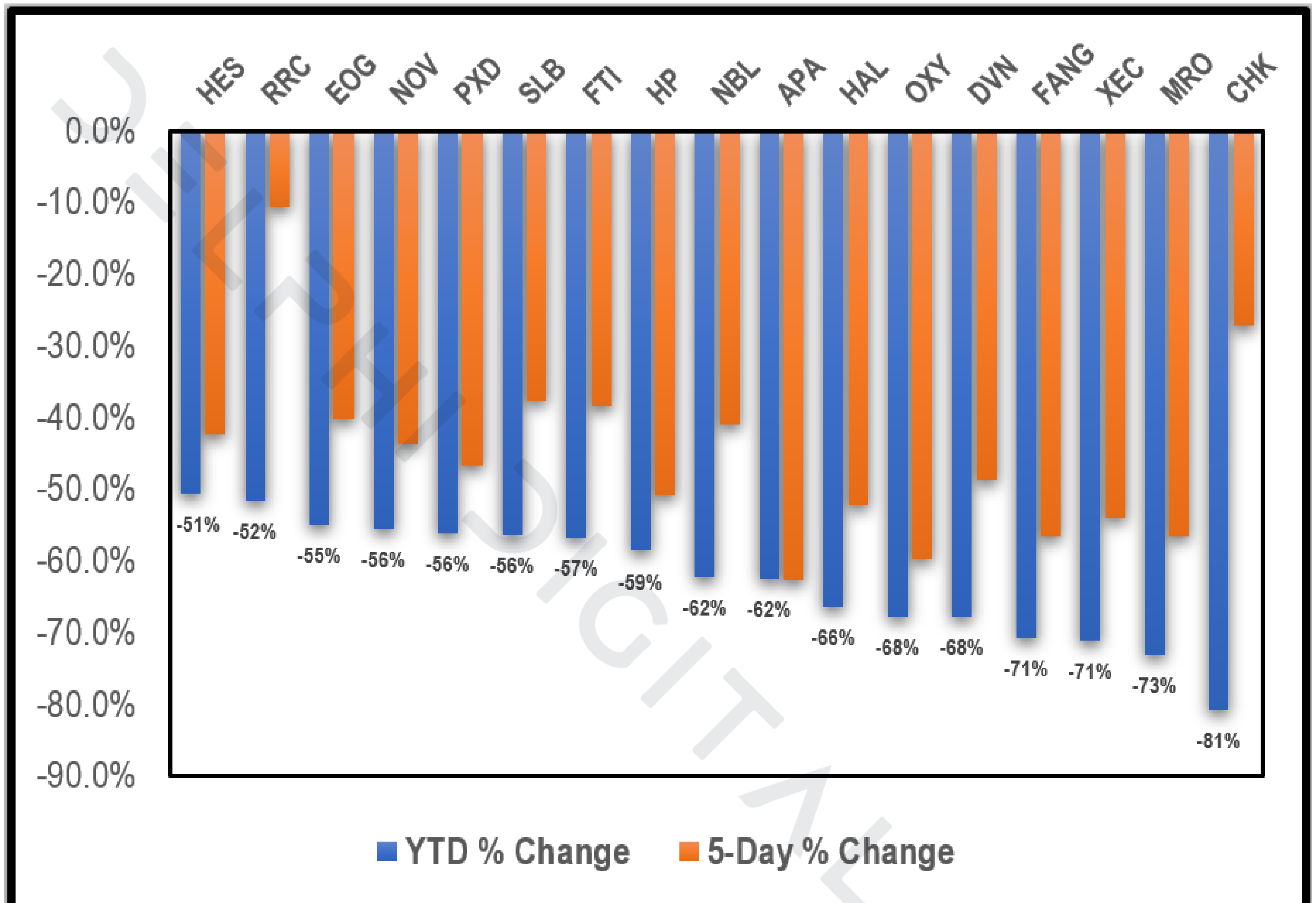
The U.S. oil & gas industry needs this like it needs a hole in its head. Many producers have cut the cost of operations in recent years following the 2015-2016 oil crash, but with crude oil now trading below ~$35/barrel, profitability is bound to come under enormous pressure if prices remain at these levels for an extended period of time. But this is just a problem for oil companies, right? Not necessarily, especially given the backdrop heading into this supply shock. We've discussed the **potential adverse effects tighter credit conditions** would have on the outlook for markets and the economy at large, which is why we're watching **credit spreads and short-term funding conditions** so closely.

While the sector makes up a small weighting in major equity indices like the S&P 500 (<4% as of today), energy companies are a considerably larger proportion of the high yield debt market. In fact, **roughly 11% of U.S. high yield issuers are energy companies,** many of which carry sizable debt burdens, making them vulnerable to any exogenous threat that could curb top line sales.

Moody's, one of the top credit rating agencies, estimates North American exploration & production companies have **$86 billion of debt coming due over the next four years,** a majority of which is speculative-grade (or "junk). If these companies run into trouble and credit conditions tighten, the **ripple effects will be felt across markets far beyond the oil industry;** at that point, the catalyst that tipped us over won't be as important as the aftermath.

*S&P 500 Worst Performing Energy Stocks YTD*




*Data as of March 9th, 2020*
*Source: SPDR*

# Bitcoin Can't Escape Panic Sell-Off

Bitcoin's latest sell-off has certainly thrown some cold water on the safe haven narrative many have touted since early last year. While it's still far too early to write off BTC as a long-term macro hedge, its recent weakness does shed some light on the general risk-on perception it can't seem to shake during periods of elevated volatility. However, the swiftness of the current sell-off across asset classes is not the result of a gradual shift away from risk; investors are selling just about anything they can find liquidity on, some of which is dumped into Treasuries or held as cash until the storm clears. Under these types of market conditions, it's no surprise BTC has taken a hit too; **gold, for example, wound up falling over 30% at one point between March and October 2008** even as market volatility began to pick up.

*Bitcoin Price vs. Inverted VIX (14-Week Avg)*


*Data as of March 9th, 2020*
*Source: TradingView, BitMEX, Cboe*

# Bitcoin's Bet on Future Monetary Policy

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Initially, I contemplated if bitcoin was trying to tell us a different story than traditional safe havens like gold or Treasuries, specifically as it relates to the outlook for central bank policy. If we rewind the clock to spring 2019, BTC's price run up began to accelerate in April while gold continued to consolidate. It wasn't until late May before the precious metal began its mid-year run up in anticipation of easier monetary conditions. Similarly, bitcoin topped out in late June while gold peaked first week of September as the Fed's tone shifted towards a more neutral policy stance.

Fast forward six months and once again we're seeing a divergence between BTC and gold with the former peaking in mid-February even as the latter shot higher.

Bitcoin is arguably the most leveraged play on more accommodative monetary policies (lower interest rates & greater stimulus measures) so it's reaction to the latest coronavirus developments is notable. However, it's important to remember the swiftness of the current sell-off and **extreme demand for proven portfolio hedges.**

*BTC vs. Gold vs. December 2020 Fed Funds Futures (Blue)*


*Data as of March 9th, 2020*

*Source: TradingView, BitMEX, CME Group*

# Treasuries Pricing in Doomsday

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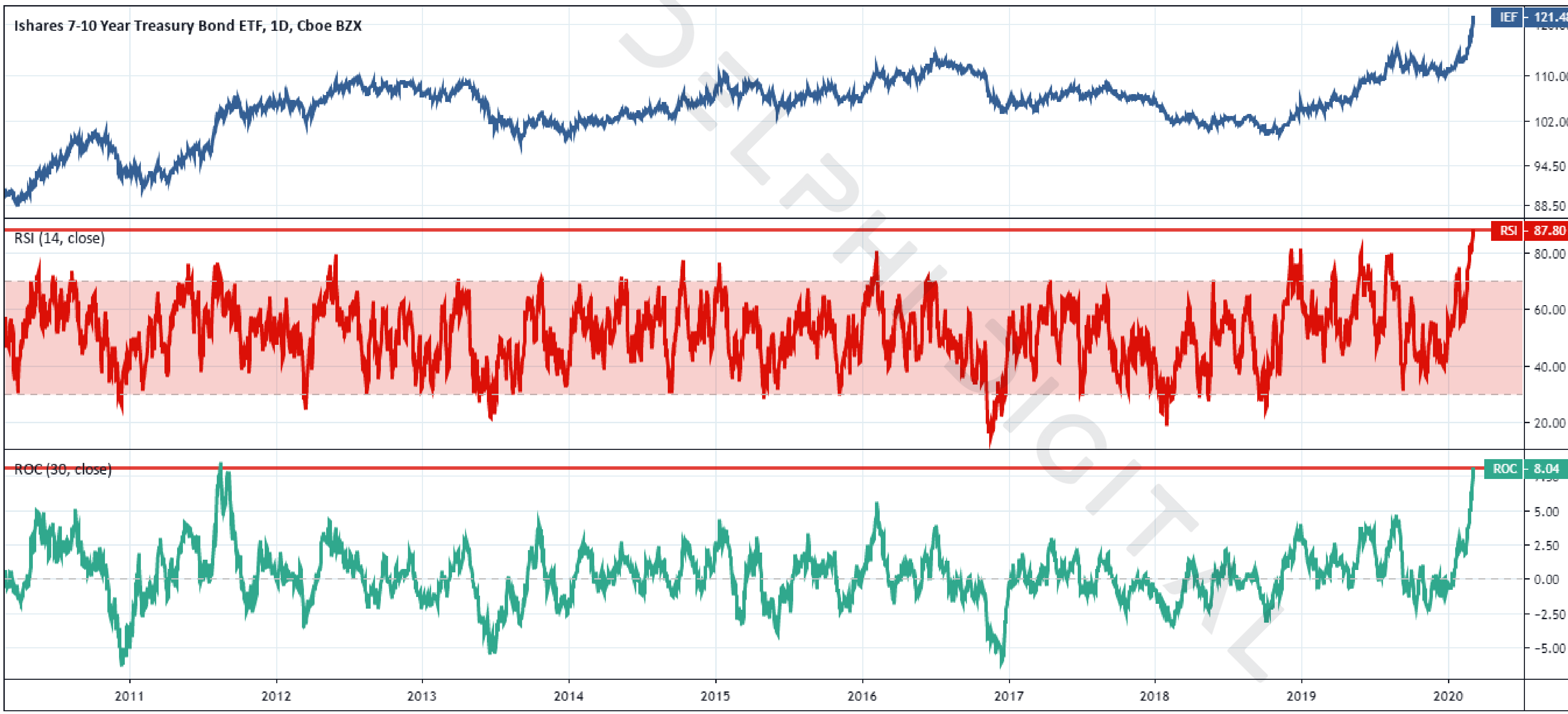
The size and strength of the latest move in Treasury bonds implies far more than a shallow recession at this point. The yield on a 10-year U.S. Treasury bond hit its lowest level on record this week as investors continue flocking to the world's "safest" asset. Long-dated Treasuries have **surged 8% over the last 30 trading days** - the biggest gain since August 2011 - pushing the asset class to its **most overbought level in at least 15 years.** Investors have rushed into Treasuries because of their stellar reputation as a "risk-free" asset, which pushed bond yields to their lowest level in history with the 10-year briefly dropping **as low as 0.4% on Monday.** At the same time, economists are slashing their growth forecasts and inflation expectations are in a free fall, adding further pressure on the long end of the Treasury curve (which tends to be influenced more heavily by the such economic factors).

*iShares 7-10YR U.S. Treasury Bond ETF (IEF) vs. 14-Day RSI & 30-Day % Change (Bottom Panel)*




*Data as of March 9th, 2020*

*Source: TradingView, BlackRock*

# Fed Rate Cut Falls on Deaf Ears

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Just because easier monetary policy is pushing on a string doesn't mean central banks will stop trying to prop up markets with bigger rate cuts or asset purchases. As we've noted, the Fed is unlikely to passively sit on the sidelines if turmoil in markets continues, especially as more pressure from investors and traders begins to stack up. Fed officials already made their first bold move by **slashing its benchmark rate 50 bps last week,** a move that surprised many despite the latest bout of volatility. Despite its efforts, the market's reversal was short-lived, with stocks continuing to weaken as Treasury yields plummeted to fresh lows.

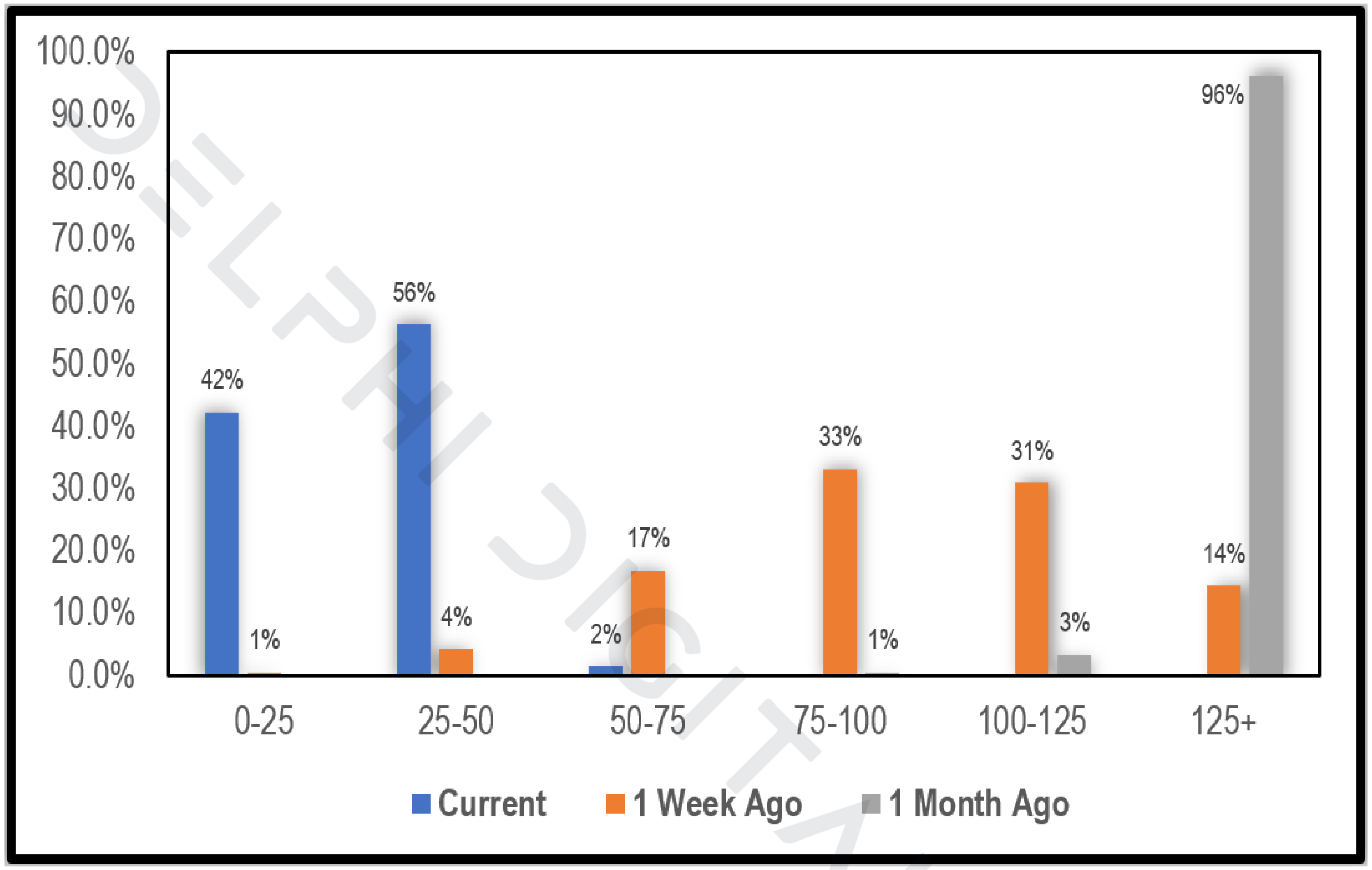
The U.S. central bank attempted to reassure markets by issuing a statement amid last week's turmoil which hinted at the possibility a rate cut would be in order sooner than later.

Notably, the Fed added similar language (i.e. "act as appropriate") back in June before it cut rates three times between July-October. **The market, however, is pricing for an even more aggressive Fed in 2020.**

The current probability of at least another 50 bps rate cut at the March FOMC meeting next week is 100% according to Fed funds futures.

More telling, however, is the fact there's now a **40% chance the Fed cuts rates to zero by the end of the year.** Yes, zero.

*Dec. 2020 Fed Funds Futures Probabilities*




*Data as of March 9th, 2020*
*Source: CME Group*

# Fed's Behind the Curve

The Fed's emergency 50 bps rate cut last week seemed surprising, but the bond market had been pricing in an aggressive move by the Fed in the weeks prior. While the Fed proclaims its independence, the latest cut came on the back of significant pressure from investors and public officials worried policymakers were behind the curve. Inflation expectations have fallen off a cliff while real yields on long-dated Treasuries just hit their lowest level since in almost seven years. The initial reaction among market participants implies a deflationary shock is more likely to hamper economic growth as demand weakens. **The Fed may be on the hook for another big move in the coming weeks if bond yields continue to fall and markets remain in a state of turmoil.**

*Fed Funds Rate vs. 2-Year & 10-Year U.S. Treasury Yields*


*Data as of March 9th, 2020*
*Source: FRED*

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