March 2nd, 2020

Fear On

- **Markets are in fear of something the central banks can not solve, but only mitigate its impact**
- **Equity markets have been bearing most of the brunt of the shift in sentiment from greed to fear**
- **Hedge funds have been doing a better job, as at least some have maintained either cautious positioning or have had outright shorts in place**
- **Corporate bonds have held up, but face some structural market issues if liquidity conditions don't ease**
- **Some areas, notably Europe, face serious logistical and budget challenges to cope with the economic disruption they potentially face with the outbreak**

After over a decade of a 'risk-on' investment environment, the markets are fear-on.

The benign world of positive asset class returns achieved seemingly with little risk-taking has been given a massive jolt. A near 10% fall in equity markets in just one week is a massive wake up call for investors. It is not just about the impact of coronavirus, but the effect of investors being reminded that risk exists. The 10% correction from a market peak was the fastest on record and the worst week for the S&P500 since 2008. Such a decline appears justified by just such a spike in macroeconomic risk. The Economist this weekend pointed out that '*if the pandemic is to be compared to very severe flu, models point to global economic growth being two percentage points lower over 12 months, at around 1%.*'

The last ten years has been an extraordinary period for markets where the returns of markets were primarily a reflection of central bank policy and little else. A one-factor model seemed to explain everything. But of course, that is not reality. There will always be risks that you can't see coming – the so-called black swans.

There are two key questions

1. Have we had investor capitulation?
2. Can governments and central banks provide sufficient help to calm the markets?

There are some signs of investor capitulation, but insufficient to make us believe that there won't be further selling pressure. Last week volumes have been very high in the stock markets; volumes in the Dow Jones index, for example, were the highest since 2006. Investors were very exposed to the downside. The promise of central banks continuing to ease policy had many investors expecting last year's rally to continue. US equity mutual funds saw redemptions of $28 billion only partly offsetting the $130 billion of inflows seen since last October.

Hedge funds per se don't look over-exposed. Hedge funds were less impacted as fewer had jumped on the pro-equity bandwagon. Equity long-short funds were on average down less than 2% in February. However, some broader fund strategies could be forced by redemptions to sell. Risk strategy funds that target a certain level of risk will be forced to sell risk assets such as equities and high yield bonds if volatility persists at these elevated levels.
In the corporate bond market, the losses have been moderate compared to equities.

For the immediate future, there will be some haven-like characteristics evident in fixed income, especially in the better-
quality credits. Over the past two weeks, the usual pecking order has asserted itself, with lower-quality high yield spreads widening out more than even the much-maligned BBB-sector.

Under a scenario of further stress and volatility, we expect his pattern to become more, not less, pronounced.
One reason for this view is the changed shape of the US corporate bond market.
Between 1998 and 2017, the share of open-ended mutual funds as holders of corporate bonds had more than doubled, from 8.4% to 19%. Arguably, it will be well above 20% by now. The rise has come at the expense of pension funds and insurance companies. The critical point here is that the market is now populated by a higher number of players who face potential fund redemptions if they underperform. With this in mind, those players are much less likely to refinance of lower-quality debt as it comes due preferring to invest in higher-quality paper. We fully expect this phenomenon to be in evidence in an economic downturn that places pressure on the operating performance of companies.

There is a clear risk that mutual fund outflows from credit funds continues spreads will widen. While this may look like an obvious conclusion, recent research (Choi, Dasgupta & Oh: November 2019), suggests that the effect is highly consistent and measurable: bonds that have a higher concentration of mutual fund holders have consistently higher spreads. A case of the tail wagging the dog?

On pure market technical indicators in the equity market, we are in no man's land. US equities (S&P500 at 2954) has fallen through the key support of 3047 the 200-day moving average. Next resistance levels are 2850 (-3.5%), 2700 (-8.6%) which was November 2018 level before the December collapse. And finally 2351 (-20%) the December 2018 low. US government bond yields have fallen precipitously with the 10-year yield at a record low of 1.15% over the weekend and cutting through 1.10% this morning in Asian trading.

To truly put the coronavirus behind us will require a medical answer which the experts suggest is at least a year away. In the meantime, there is a wait for action from policymakers. To be sure central banks and governments can provide help for the economy. But if countries had thought there was an easy answer, they would have already done it. With interest rates in most parts of the world near record lows and governments carrying enormous levels of debt, many policymakers will keen to use their last bullets wisely. If the Federal Reserve truly believes that a 0% interest rate is the lowest they will go to, they have just 1.5% of interest rate cuts to use. Governments could use helicopter money and like Hong Kong, just put money into each citizens bank account. But merely putting money into a citizens bank account is not going to mitigate their fear of the virus.

Countries would do well to follow the model of Singapore, where you encourage and coerce best practices to control the spread of the virus. We have hand wash in every public building, staggered working, cancellations of any meeting of more than ten people and people quite frankly staying at home more often. It is all about risk mitigation. If your country is not yet doing these things, then at least prepare yourself for them.

The epicentre of the European outbreak, Italy, represents the weakest point in the Eurozone economy, and at a fragile time. The Italian economy had already contracted by 0.3% in the last quarter of 2019 and now looks to be heading into recession as it grapples with the disruption.

There is every reason to believe that the economy will shrink this year overall. Despite better news last week from Germany and positive noises from the ECB followed by a rebound in the euro, this would have serious knock-on effects on the broader Eurozone. The ECB is limited in what it can do with a supply-side shock of this nature – all of which adds grist to the debate over a meaningful fiscal stimulus or at least the EU Commission tolerance of a higher Italian budget shortfall.

Beyond all that, worries persist about the impact of the crisis on European politics; questions again regarding the risks presented by the passport-free Schengen zone. At this point, there appears to be a patchwork of responses of varying severity across the region. Health policies have a national remit rather than a European one. Once again the battle lines are drawn between the proponents of 'more' and 'less' Europe.
The case for an integrated Union-approach is there – it is the political well to deliver it that is in question. The challenge is happening right now.

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