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COVID-19 widens reach into U.S., causing market volatility to surge

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COVID-19 broadened its reach into the U.S. this week, sparking the sharpest equity market sell-off in a decade. Interest rates have also fallen to record lows as investors flood into safe-haven assets. We offer an update on U.S. economic risks and resiliency as well as potential further policy response. Uncertainty is likely to remain heightened despite policymakers' efforts at being proactive, meaning investors should brace for further volatility for months to come.

Volatility is the new normal

Equity markets suffered the worst price decline in over a decade on Monday, March 9, as the Dow shed over 2,000 points and the S&P 500 ended the day down -7.60%. The sell-off became so severe that market circuit-breakers were automatically triggered for the first time since 1997. COVID-19 news is evolving fast, and the number of communities in the U.S. reporting cases is growing rapidly. News that Italy quarantined its northern half, only to quickly expand that to the entire country, is being viewed as a case study for the rest of Europe. In short, most virus-related news over the weekend was not positive and only seems to be raising uncertainty.

Even for investors who had already experienced two weeks of rocky markets, Monday was a brutal reminder of the devastation that volatility can wreak on a portfolio. The S&P 500 closed Monday down -18.9% from its high on February 19, just shy of the typical 20% threshold for a bear market. Nine months of market gains have evaporated in just under three weeks.

S&P 500 GIVES UP 9 MONTHS OF RETURNS

Source: Bloomberg Finance, L.P., as of March 9, 2020.

As Tuesday unfolded, there were welcome signs of stabilization in prices with the S&P 500 up almost 3.0% at the time of writing.[1] However, this could be seen as more of a break than the beginning of a recovery. The VIX index, a forward-looking measure of expected volatility, hit 62.1 Monday, the highest mark since 2009.[2] As of this writing, this measure was still sharply elevated at 53.6 – hardly an indication that market jitters have meaningfully evaporated.

Volatility begets volatility: A painful reminder from oil markets

Monday was also a painful reminder that volatility begets volatility. Crude oil prices plunged more than 25% over the weekend, with WTI crude trading as low as $27/bbl before settling into the low $30/bbl range. This is down more than 50% below the start of the year. Brent crude, the global benchmark, suffered its second-largest one-day decline ever, trailing only the sell-off during the 1991 Gulf War.

These eye-popping swings were brought about by a breakup in the Russia-OPEC alliance (dubbed OPEC+), which was created following the 2015 price collapse to stabilize oil markets. It was a weekend filled with drama: Russia shocked markets by refusing to go along with OPEC on further production cuts – an effort aimed at supporting prices amid mounting demand concerns. Saudi Arabia responded by cutting prices drastically overnight and promising to ramp up production. Russia has responded in kind, also promising to raise production, leading to an all-out price war among the world's largest producers.

This environment will have a significant impact on U.S. shale production, which generally has a break-even price in the $40–$50/bbl range. The downside case likely looks similar to 2014-15, which saw business investment in energy structures fall by 64% and employment

1 As of 3:00 PM ET on Tuesday March, 10.

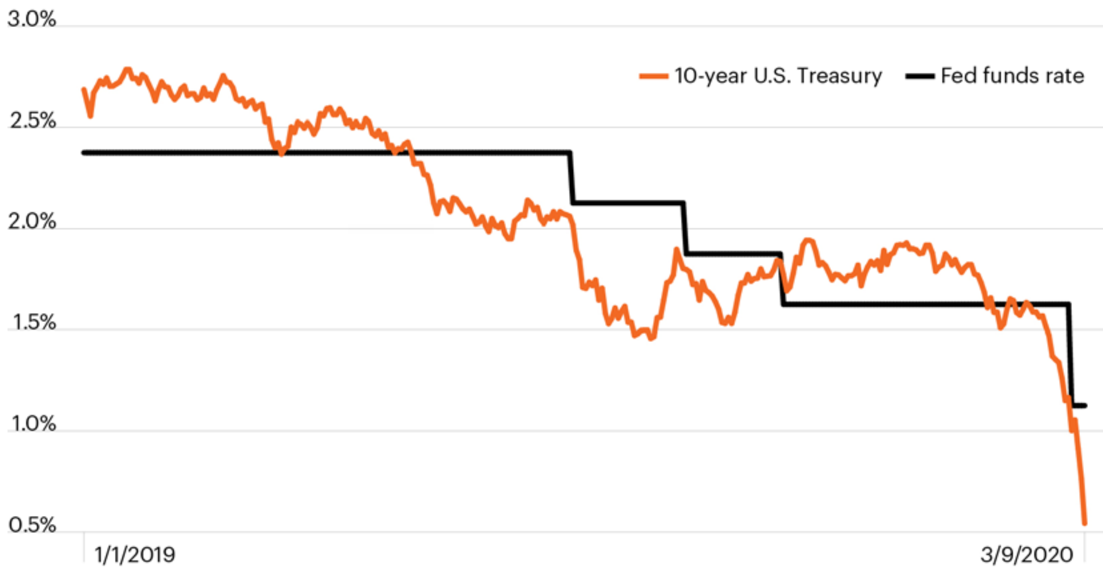
2 Bloomberg Finance, L.P., as of March 9, 2020.

in the oil and gas industry decline by 36%. The relative size of the energy industry as a share of the total U.S. economy has fallen since then, suggesting less of a direct impact to U.S. growth. Nevertheless, there could certainly be knock-on impact from financial market fallout.

U.S. Treasury yields, how low can you go?

Last week's surprise 50 bps rate cut to 1.00–1.25% by the Fed further greased the slide of interest rates across the U.S. Treasury curve. The 10-year continued to plumb new lows on Monday, falling as low as 0.33%. Not to be outdone in the arena of volatility, overnight trading saw the 10-year Treasury sell off sharply, and yields climbed to over 0.73% in early trading Monday. The MOVE Index,[3] which measures forward-looking Treasury market volatility, spiked to 163.7 on Tuesday, also the highest since 2009.

U.S. TREASURY YIELDS HIT RECORD LOWS



Source: Federal Reserve, as of March 9, 2020.

Here fixed income investors could also feel the sting of volatility. As the duration of core fixed income portfolios has lengthened, the price sensitivity to changes in yield has surged. Unfortunately, investors thinking that core fixed income offers a safe haven from the storm may be in for an unwelcome surprise. U.S. Treasuries offer the safest credit rating but now yield so little that income gains are virtually non-existent, leaving price changes in the driver seat for total returns.

The economy and policymakers brace for impact

A looming uncertainty driving much of this volatility is what impact COVID-19 will ultimately have on the economy. Let's focus on some good news: the U.S. economy is the biggest, arguably the healthiest, and in many ways the most resilient in the world. Last week, the February payroll report delivered a big upside surprise as our economy added 273,000 jobs and the unemployment rate fell back to 3.5%, a multidecade low. In many ways, our economy is in prime shape to handle the challenges that are sure to come.

3 The ICE BofAML MOVE Index measures implied volatility on 1-month Treasury options.

Nevertheless, there will almost certainly be an impact on our economy in 2020. To this end, policymakers are already taking action. The rate cut was just the first move by the Fed. Markets are expecting over 50 bps of rate cuts at the upcoming March 18 FOMC meeting and expect the Fed funds rate to be back to zero by June.[4] Fed rate cuts are an important and obvious policy support, but even the Fed is well aware that this is hardly a silver bullet in the face of unprecedented uncertainty to U.S. growth. Exactly how effective can Fed rate cuts be against the coronavirus? The Fed is sending a clear signal that, whatever else the economy may face, it does not want a banking-induced shortage of liquidity to be an additional problem.

Discussion of fiscal stimulus is growing louder. Measures that policymakers may pull from the playbook include extending unemployment insurance benefits and offering loan assistance to industries or sectors (for example, small businesses). Payroll tax cuts have been mentioned. The government has greater potential to impact the economy than monetary policy, but also takes more time to put policy in place.

As we look ahead to growth in 2020, it is too early to place numerical probabilities on whether or not we will have a recession or speculate as to what shape any downturn may take. Ironically, February retail sales may be quite high as everyone I know seems to be stocking up on water, hand sanitizer and frozen pizzas. Imports from China have fallen, which will be a positive for Q1 GDP. The economy reacts much slower than financial markets.

For now, the key takeaways for investors are to prepare for and manage volatility, and to intensify the search for income. Uncertainty will likely linger for much of the year, causing heightened volatility which could, at times, become extreme. Interest rates are likely to continue to plumb new lows, leaving core fixed income investments with rapidly disappearing income.

4 Implied rate cut probabilities are based on Fed funds futures pricing on Bloomberg Finance, L.P., as of March 9, 2020.

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