Tracking market implications of a pandemic

As the COVID-19 coronavirus pandemic continues to shake markets, major efforts from Central Banks and governments around the world aim to curtail negative economic repercussions. Are we headed towards a recession? How are major asset classes faring? Experts from Mellon share their view.

After the Federal Reserve (Fed) cut interest rates to a range of 0-0.25%, on March 15 (and indicated it would purchase at least US$500bn in treasury securities and US$200bn in mortgage-backed securities) stock markets had an initial knee-jerk reaction, which led to some of the largest single-day declines since Black Monday in 1987.

“We’re also entering the time frame in which the data should roll over from the disruption in economic activity: the downward leg of the V. If there are more declines in financial wealth and oil prices, it exposes weaknesses on national, firm and household balance sheets, which could tip the economy into a recession,” says Vincent Reinhart, chief economist and macro strategist at Mellon.

Reinhart places a 40% probability on a projected V-shaped recovery turning into a U-shape recovery, but adds that if a V-shape recovery does in fact ensue, it could have lasting effects on central bank policy:

“On the other side of the baseline, a sharper and more distinct V-shape path of a recovery would expose fiscal and monetary policies to be locked into an L-shaped copilot accommodation. Fiscal stimulus never gets reversed, even when its shelf life passes,” Reinhart says. "We suspect officials would be hesitant to remove unusual accommodation in 2020 due to the possibility of economic conditions lagging.”

In regard to how markets are responding, on March 16 the Chicago Board Option Exchange’s Volatility Index (VIX) closed over 82, a record high, signaling a severe level of volatility.

“While equities tend to get the most airtime, the real main attraction is the fixed income space,” says Dragan Skoko, head of trading and trade analytics at Mellon. “The US treasury market has been under quite a bit of stress, but we believe the Fed action with quantitative easing is going to start working its way through the system and will alleviate the pressure of this market.”

Views on fixed income

David Leduc, senior portfolio manager of the BNY Mellon Global Fixed Income Fund and CIO, head of fixed income at Mellon, believes many investors are trying to gain liquidity in anything they can sell right now. Because of this offloading, there has been a distinct difference in how primary and secondary markets are behaving.

“Currently, high-quality parts of the market, such as short-dated high-quality corporates, highly-rated asset backed securities, are all trading materially lower from where they were at the
beginning of the year,” Leduc says. “There’s been a dramatic repricing as some individuals are looking to get liquidity, and it’s had a disproportionate impact on a lot of high-quality assets.”

While this is largely taking place in the secondary market, according to Leduc, the new issue market is a different story for large and higher-quality corporations, which are not as exposed to industries of major concern.

“We’ve seen large deals from high-quality issuers in the telecommunications space, as well as utilities and high-quality energy. In addition to those issuers, consumer products and beverage companies are coming to market with large deals at attractive spreads,” says Leduc.

The dislocation in the secondary market is largely due to managers who are trying to meet redemptions or rebalance portfolios, thinks Leduc. “On the other hand, we think there are clearly managers out there who have enough liquidity to access high-quality issues in the new issue market.”

Leduc and his team believe that, when the economy does finally recover, a number of issuers will remain high-quality, which offer attractive spreads at their current levels.

A rollercoaster for stocks

John Porter, senior portfolio manager of BNY Mellon Small-Mid Cap Growth Fund and CIO, head of equities at Mellon, is optimistic that once we’re on the tail end of the pandemic, the market and the economy may be set for a strong recovery, but he admits that the fall in stocks has been quite staggering.

“This is the fastest move we’ve seen equity markets make from all-time highs to a bear market. At this moment, near-term visibility isn’t too clear,” he says. “Emotion is ruling the market right now, but we’re trying to maintain our focus on company fundamentals and long-term earnings power.”

Leverage has become one of the most important financial metrics in this environment, he adds.

“Relative to a month ago, we’re much more mindful of leverage, both financial and operational. We naturally have a bias toward higher-quality, better capitalized companies, but in this environment we’re certainly escalating the importance of that in our analysis.”
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