

Frequently Asked Questions: Capital Markets in Crisis

March 19, 2020

Our investment team has provided answers to questions about our view of the capital markets amid ongoing uncertainty surrounding the COVID-19 pandemic. All of the following opinions and data are as of March 19, 2020; our views may shift with the rapidly-moving market conditions and virus news.

Q. What are your macro views given the ongoing volatility and uncertainty caused by the novel coronavirus (COVID-19)?

- A.** The coronavirus (COVID-19) outbreak is a black swan that has radically changed our global economic outlook. At the start of 2020 we were hopeful for continued global economic growth and optimistic that more countries would join the expansion. Unfortunately, that is not happening right now. There are already European countries (such as Italy) that appear to be falling into a recession.

We remain hopeful that China's economy will stabilize; the spread of COVID-19 in the country appears to have slowed, which should reignite internal demand. Although, the nation's exports will likely be impeded by recession in the rest of the world.

In contrast to China, Europe and the U.S. continue to face difficulties that should require increasingly draconian measures. The spread of COVID-19 in Italy still outpaces that of the rest of Europe, but other countries are not far behind; we contend that the U.S. is likely 10 days behind Italy. We are starting to see a ramping-up in testing for the virus in the U.S., which should make the reported number of cases dramatically worse. Overall, we need to see the curve of new cases bend lower in the U.S. before its healthcare system becomes overwhelmed (which is already happening in Italy).

The "big guns" are out for both fiscal and monetary policy in affected countries. During the week ending March 20, 2020, the U.S. Federal Reserve (Fed) cut interest rates back to zero. Other countries are following suit; some are taking pages out of the 2008 global financial crisis playbook. We expect Europe will throw away its fiscal responsibilities and do the same thing. So far, with legislation in place, deficits have increased globally by 1% to 2%, and should increase rapidly as additional measures to support income and industries take place.

In our view, equity markets are dramatically oversold, but this won't mean much until we see some light at the end of the tunnel with a decelerating number of reported COVID-19 cases globally.

Q. How do you think U.S. fixed-income markets are faring in this environment?

- A.** Emergency programs are coming out in piecemeal from the Fed and at varying levels of the U.S. government. We think the Fed's actions thus far have helped, but uncertainty remains. Investors are likely looking for coordination on these activities.

In the U.S., there is not a lot of liquidity in the fixed-income market. American companies appear to be trying to raise liquidity wherever possible. In our view, investors who are overweight the front end of the yield curve will likely be hurt in the short-term as investors race to raise liquidity. Within financials, subordinated structures appear to be hit harder than senior structures. After we get through this, we anticipate a lot of issuance with some concessions.

Money-market funds are moving toward shorter maturities as, similar to 2008, people have begun to hoard cash. We began to see dislocations in both the healthcare and automotive industries when this crisis started ramping up, which is also reminiscent of 2008.

In the Treasury market, the magnitude of moves are similar to those experienced during the global financial crisis, although this time Treasuries started at a comparatively lower point.

All sectors in the high-yield market were down significantly in the year to date as of March 19, 2020, especially energy, leisure and automotive. We believe that some energy names may not survive. Within oil markets, we anticipate a significant number of BBB rated oil companies will be downgraded to below investment-grade due to the oil-production dispute between Saudi Arabia and Russia (which caused prices to plummet) and as COVID-19 has caused lower demand for oil.

Q. What is SEI's view of the global bond market in the context of this crisis?

- A. We view the central bank actions in recent weeks as necessary but no panacea, as evidenced by the continued re-pricing of risk assets. In our view, there needs to be more fiscal assistance from governments. Banks have capital and liquidity, but need a risk appetite to lend—which is where we think government guarantees need to come in. In Europe, there's talk of Germany relaxing its debt brake, which would be a great help. Germany has more fiscal headroom than probably any other major economy and so now's the time to use that. We expect the inflection point will coincide with the point of maximum pessimism and low trading volumes—both of which are only apparent after the fact.

Investors generally appear concerned that bonds will not prove to adequately offset equity losses for the month.

Q. How do you think the crisis has impacted emerging markets (debt and equities)?

- A. Emerging-market sovereign debt has been struggling since the start of 2020. Latin America, Middle East and Africa local-currency debt have all declined significantly since the New Year; emerging Europe and Asia local-currency debt have also dropped, but to a less significant degree (Asia is an oil importer, and has therefore benefited from lower prices).

Many emerging-market countries have effectively shut down in response to the COVID-19 pandemic, partly as their healthcare systems would not be able to cope with a dramatic uptick in cases. Brazil in particular has struggled as the Brazilian real (BRL) plummeted to less than \$5 BRL per U.S. dollar on March 19, 2020. Ukraine and Egypt should benefit from having strong International Monetary Fund backing.

In emerging-market equities, Chinese financials have fared better than other countries; likely as Hong Kong and China are gradually returning to normal, with most new COVID-19 cases are reportedly from outside travelers.

Q. How are U.S. equities faring amid the COVID-19 crisis?

- A. U.S. small-cap stocks have experienced the brunt of the selloff so far, with indiscriminate selling across sectors. Stability-oriented securities has not fared as well as one may expect in a selloff, but, as we mentioned earlier, selling has been mostly indiscriminate and sometimes without regard to quality. We have maintained our preference for value—although we also note that this is largely strategic and is measured versus broad-based market indexes. Many of the large technology and technology-related companies that were leading through the end of 2019 have continued to do so in the downturn. This positioning has hurt, but we remain steadfast in our belief that value will have its day.

Q. How are global equities faring in this environment?

- A. On extreme down days, we have seen wholesale liquidations as investors moved to cash. In factor terms, from February 19 to March 19, corporate profitability has performed well (profitability is correlated with solvency or low debt). Stability has performed well, but the performance has been uneven. Value has been struggling, but we have seen some short-term corrections in the past couple of weeks. Low volatility has been performing moderately well, but not as strongly as we would expect in this environment. Momentum-oriented stocks have been weaker in the U.K.

than in Europe, as domestic consumer stocks that gained on the Brexit resolution retreated once again on the COVID-19 crisis.

Despite the big market falls, there has been no real change in sector leadership; energy and airlines were already falling out of favor prior to the pandemic. We maintain our preference for value, which we view as massively oversold.

Q. What is your current view of non-traditional assets (such as securitized loans and distressed debt)?

- A.** Stresses in the credit markets are pretty bad, particularly in the business development company sector. Banks appear to be in better shape. We think the loan market is on pace for the worst month in history. As for the oil, prices could go negative due to storage cost but then bounce back over \$100 per barrel within a few years.

With all that said, in our view, valuations don't mean much right now: It is all about survival and raising cash. Outflows are shattering records set in 2008, mostly from exchange-traded funds and mutual funds. We were in a credit bubble going into this, so it is hard to know if any amount of stimulus could save some companies. Treasury markets must function before credit markets can function again, although Treasuries appear to be trading more on liquidity than fundamentals.

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