STOCKS

Rally, Retest, Repeat?

After a harrowing week to close out February, with the S&P 500 dropping 12.7% in the last 6 trading days of the month, equity investors found themselves asking “is it over, yet?” If the first week of trading in March is any indication, it isn’t. We look to history to provide some clue as to how this pullback ultimately plays out. Stocks have occasionally, albeit rarely, formed a ‘V-shape’ bottom, rallying sharply after deep pullbacks or corrections without re-testing lows. If history is any indication, the S&P 500 chart is more likely to form a series of “W’s” as the rapid pace and depth of the sell-off, down 19% from the February market peak to the current trough at the time of this writing, may lead to bottom-fishing before re-testing or potentially making new lows as coronavirus spreads and its global economic impacts are fully appreciated. Leading up to 1st quarter earnings season in April, we expect negative earnings pre-announcements to accelerate as companies play the coronavirus card as justification for poor operational performance. Appropriately setting investor expectations is important, but heightened economic uncertainty isn’t going away any time soon, making guidance suspect and subject to further negative revision down the road, likely weighing on investor sentiment and risk appetite.

THE ECONOMY

Heightened Market Volatility; Heightened Economic Uncertainty

In the early weeks of 2020, we found ourselves spending a lot of time fretting over how complacent we thought many analysts had become. First it was what we thought was complacency over the outlook for the U.S. economy in 2020, then it was what we thought was complacency over the potential impact of the coronavirus. As we write this in early March, however, we can say, with a high degree of certainty, complacency is no longer an issue. Which in terms of the outlook for the U.S. economy and the global economy, is pretty much the only thing that can be said with any degree, let alone a high degree, of certainty right now.

Those who had been complacent were no longer so upon the realization that the coronavirus had become a global issue, and that the U.S. economy was more vulnerable than had commonly been assumed. In the early phases, many viewed the coronavirus as largely being a health issue for China that, to the extent it disrupted economic activity in China, posed a threat to global supply chains. As such, many saw it as a potential transitory supply shock that could lead to temporary disruptions in the U.S. economy. As the virus began to spread around the globe, including into the U.S., the realization that it also posed a threat to the demand side of the economy began to take hold. In other words, the coronavirus at once represents a potential supply shock and a potential demand shock which, if of sufficient dimension, could push the U.S. economy and the global economy into recession. That no one can, at this point in time, know how broadly the virus will spread, how long it will pose a threat, how consumers will react, and how severe any disruption to economic activity will be adds extra layers of uncertainty.

While the financial markets are pricing in a severe hit to the U.S. economy, thus far there are few visible effects in the regular economic data, much of which is being dismissed out of hand as “old news.” The February employment report is a case in point, as the February payroll survey week (which each month is the week including the 12th of the month) ended prior to there being signs that the coronavirus had spread to the U.S. Total nonfarm employment rose by 273,000 jobs in February, with prior estimates of job growth in December and January revised up by a net 85,000 jobs for the two-month period, while the unemployment rate fell back to 3.5 percent, a rate that until recently had last been seen 50 years ago. Had these numbers come out two months ago, or even one month ago, they would have sent equity prices and bond yields higher. Coming on the first Friday of March, however, they did little, if anything, to stem further declines in equity prices and bond yields. Still, our view is that starting points matter, and the February employment report showed that the labor market was on solid footing when first confronted with the effects of the coronavirus, as was the case with the broader economy.

There are some higher frequency data series that will take on added importance in the weeks ahead. The weekly data on initial claims for Unemployment Insurance will be where any effects of the virus on the labor market appear first. As of the week ending February 29, however, initial claims remained notably low. One caveat regarding initial claims is that in a labor market this tight, firms may not be as quick to lay off workers in response to a transitory disruption in business activity, particularly given what have been growing concerns over shortages of skilled labor and the costs involved in searching for and onboarding new employees. As such, the monthly employment reports will remain relevant. Keep in mind that the headline job growth number is a net number, reflecting the difference between the number of workers coming on to payrolls and the number of workers rolling off payrolls. While firms may be hesitant to let current workers go, they would surely be quick to cease hiring new workers, such that measured monthly job growth could decline sharply even absent a spike in initial claims.

Higher frequency measures of consumer sentiment, such as Bloomberg’s weekly Consumer Comfort Index and Morning Consult’s Daily Consumer Confidence Index, will take on added importance as they would quickly pick up a marked deterioration in consumer sentiment that would presage a pullback in consumer spending. Both measures have indeed fallen of late, but remain at fairly high levels, and as such are not sending up warning flags as to consumer spending. That could reflect consumers giving more weight to labor market conditions, which to this point remain strong. That said, should there be a rapid acceleration in the spread of the coronavirus across the U.S., these sentiment measures could fall far and fast, which would raise the possibility of a pronounced pullback in consumer spending.

At this point, the only honest, even if not very satisfactory, answer anyone can give to the question of the economic impact of the coronavirus is “we don’t know.” Being able to identify the various channels through which the virus may impact the economy is not the same as being able to quantify the timing, magnitude, and duration of any such effects. As such, we’ll monitor the data and be more specific as the data allow.

The FOMC cut the Fed funds rate target range by 50 basis points on March 3, ahead of the March 17-18 FOMC meeting, in response to the growing downside risks the coronavirus poses to the U.S. economy and the financial markets. While no one thinks cutting the Fed funds rate will remedy impaired global supply chains or prop up consumer confidence, the FOMC’s concern is with overall financial conditions and the functioning of the credit markets. It is on these grounds that the FOMC will base its decisions, and we look for the funds rate to be cut further at this month’s FOMC meeting.

Source: BLS; Bloomberg; Morning Consult
A spike in equity volatility to close out February was unsettling, with the CBOE Volatility Index, or VIX, making a parabolic move to 49, up from just 18 the prior month, and a level last seen in 2009. Investors sought out hedges as a means of protecting equity holdings from additional downside, paying whatever the cost, leading to rising demand for put options - contracts that increase in value as equity indices or individual stocks tied to the option decline in price. After emerging from the depths of the Global Financial Crisis in early 2009, market participants have grown accustomed to a regime of lower volatility, with average VIX readings in the mid-teens versus around 20 historically. Over the prior decade, market selloffs have often been accompanied by VIX peaking close to 30. In 2010 and 2011, readings reached the low-40s' - but a VIX spike to near 50 at the end of February and another to around 60 in early March were most unwelcome blasts from the past.

Recent volatility is a function of aggressive portfolio positioning entering February and 'free' money stemming from excess global liquidity and low interest rates being pulled out of stocks as coronavirus spread and oil prices cratered. Many hedge funds and large institutional investors were nearing maximum allocations to stocks prior to the coronavirus outbreak, volatility pulled out of the market as global risk sentiment unwound as the global economic backdrop has become increasingly uncertain. Volatility is likely to remain elevated throughout March and into April, but with a VIX spike above 60 in early March, a few signs are pointing toward a peak in panic potentially being near. First, the put/call ratio, a measure of demand for portfolio protection relative to demand for options tied to market appreciation, has climbed to a level last seen during the 4th quarter of 2018 sell-off that took the S&P 500 down nearly 20%. Secondly, all but one S&P 500 sector fell 10%+

INVESTMENT STRATEGY OUTLOOK

Bonds Favor Quality Amid Heightened Equity Volatility

New cases of coronavirus popping up in the U.S. while also spreading throughout Italy, South Korea, and Iran, among other locales, led U.S. Treasury yields lower across the curve over the last three weeks of February and into early March. To close out February, the 10-year yield dropped to 1.13% while the 30-year yield fell to 1.65% as heightened global economic uncertainty along with expectations for coordinated monetary policy moves out of global central banks served to pull yields on long-dated Treasuries into all-time low territory. To begin March, and with coronavirus-induced hysteria on the rise, fed funds futures placed a 100% probability on at least a 50-basis point cut to the fed funds rate by the end of the first quarter. The Federal Open Market Committee (FOMC), facing mounting pressure to do something, cut by 50 bps on March 3. The 10-year yield is now hovering around 0.60% while the 30-year is at 1.0%.

With the 3-month/10-year portion of the yield curve inverted by 14 basis points at the end of February, tightening financial conditions, and with economic growth projections increasingly up in the air, a sizable half-point cut was required to normalize/steepen the curve. However, the FOMC’s decisive move comes at a cost, as it now has even fewer monetary policy tools at its disposal should the economic backdrop deteriorate further. Liquidity, which the half-point cut addresses, hasn’t been of concern up to this point, and in our view the latest rate move is likely to do little to impact or boost consumer confidence or investor sentiment as coronavirus continues to spread. With that said, increased liquidity might generate demand for investment-grade and high yield corporates as it pushes capital out of ‘safe,’ lower yielding securities and into higher yielding ones. The FOMC’s move may afford investors an opportunity to reduce exposure to corporate credit at better prices.

It’s difficult for us to argue that significant upside potential remains in U.S. Treasuries with yields at or near current all-time low levels, but as coronavirus spreads, significantly altering global supply chains and consumer spending patterns, it’s easy to formulate a basis for why yields might grind lower still alongside additional accommodative, and potentially coordinated monetary policy moves out of the FOMC and foreign central banks. In investing, sometimes playing defense can be the best offense. Amid the backdrop we envision developing over the coming month, and with yields low and credit spreads under pressure, we’re comfortable playing defense within fixed income portfolios at the present time. ▲

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