Investment Event
Uncertainty breeds volatility

Equity markets fell sharply and Treasury yields touched new lows following an abrupt decline in oil prices and further bad news on the COVID-19 outbreak in Italy

A concerted effort by policy makers to shore up the growth outlook and confidence is likely to be needed to calm investors' nerves

Our views

We estimate that holding a moderate pro-risk stance can produce adequate returns for long-term investors. Nevertheless, given elevated levels of uncertainty, we believe there is still a strong case for a more cautious near-term strategy

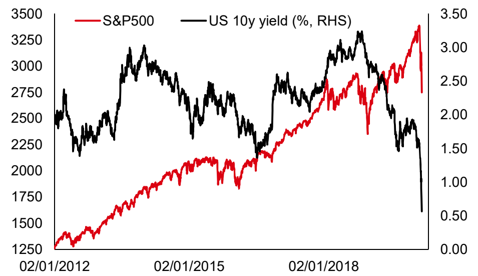
Equity market correction gathers pace

Risk-off sentiment in financial markets intensified significantly on Monday 9 March. Equity markets fell heavily across developed and emerging markets (DM and EM). The S&P 500 finished the day down by 7.6%, the largest one-day fall since 1 December 2008. The S&P 500 has now dropped by over 12% in the last three trading days. Perceived safe-haven assets, particularly high-rated government bonds, have rallied hard. The yields on 10 and 30-year US Treasuries fell to record lows; the 30-year yield dropped below 0.70% intra-day before recovering to a little over 1.00%.

Monday's sharp market moves followed:

- An abrupt fall in oil prices amid a breakdown in relations between Russia and Saudi Arabia, effectively triggering what could turn out to be an all-out price war. For more details on this please see our Investment Event "Oil prices fall sharply" (9 March 2020).
- News over the weekend that Italian authorities have locked down a number of regions in Northern Italy affecting around 16 million people in an attempt to contain the outbreak of COVID-19.

Figure 1: US yields and equities slump



Source: Bloomberg, Data as at 09 March 2020. **Past performance is not a reliable indicator of future returns.**

The current level of market volatility is rare and reflects the unusually uncertain outlook. We have previously noted that investor psychology appears caught between two camps: (i) concerns over the economic impact of COVID-19, particularly on corporate fundamentals; and (ii) optimism that policy measures can mitigate the economic costs. Tension between these forces is resulting in volatile markets.

In recent days, the news has been largely one way; more stringent measures to control the COVID-19 outbreak, but little by way of large-scale policy easing to offset the perceived increase in the economic cost of the disease.

What can policy makers do?

There is unlikely to be a single silver bullet to deal with the challenges currently facing economies and markets. Ultimately the response most probably needs to be a package of monetary and fiscal action with a focus on measures that provide short-term cash-flow relief to businesses and households. These could include: interest rate cuts where possible; liquidity operations to provide cheap funding to banks along with incentives to ensure the money flows through to firms and consumers; wage subsidies; tax relief; public-sector guarantees of some short-term loans; direct public-sector support for key industries that have been hit hard by supply-chain disruption or sharp reductions in demand. Ideally, these would be implemented across major economies.

Overall, the aim of policy should be to limit the extent of the impact the public health emergency has on economic activity. This requires policies to support supply and demand. Such action would not necessarily lead to an immediate, sustained improvement in risk appetite but could help stabilise the situation and allow an economic and market recovery, if and when there is greater confidence that the COVID-19 outbreaks will be brought under control.

Market consideration

Based on current valuations, we estimate that holding a moderate pro-risk stance can produce adequate returns for long-term investors. Nevertheless, given elevated levels of uncertainty, we believe there is still a strong case for a more cautious near-term strategy focused on:

- **Greater selectivity in the risk assets we hold**. Given we see greater potential for policy stimulus in the US, China and many Emerging Markets (EM), we believe it makes sense to allocate a higher weight to EM and US equities relative to the eurozone and Japan, where policy is more constrained.
- **“Smart diversification”** that encompasses alternative asset classes as a way to build up portfolio resilience in this “age of uncertainty”.

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