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MARKET UPDATE
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Markets in crisis: key questions on investors' minds

As market volatility surges, the Federal Reserve cuts rates to zero, oil prices plummet and more governments and policymakers around the world close borders and enact quarantines, investors are struggling to know what to make of what is happening and what they should do with their portfolios. Nuveen's Global Investment Committee provides some perspective on the key questions we're hearing from our clients.

Insights from

Nuveen's Global Investment Committee

WHAT IS THE CURRENT STATE OF LIQUIDITY ACROSS FINANCIAL MARKETS?

Some markets are clearly troubled, such as the short-term commercial paper market (which is why the Federal Reserve stepped in again this morning to inject liquidity into those markets). But even outside of the markets that are making headlines, we are seeing some liquidity pressures. Everything from municipal bonds to publicly-traded equities have been seeing wider bid/ask spreads than normal as stock prices and bond yields plunged and credit spreads moved wider.

We would categorize market liquidity as stressed, but markets are still functioning. Our portfolio management teams are able to buy what they need to buy and sell what they need to sell.

WHAT SIGNALS COULD INDICATE WE ARE APPROACHING A BOTTOM?

Another way to ask this question is to gauge whether risks are accurately being priced into the markets today. The speed and magnitude of the market selloff is seen by some as an overreaction. However, it's important to remember that stocks and other risk assets were fully or overvalued before the panic selling started, which contributed to the rapid selloffs. Given the degree of unknowns, it's hard to tell how much downside risk is still embedded in the markets. Our best sense at this point is that we may be past the worst of the panic selling across asset classes, but volatility is likely to be elevated in both directions. For stocks, for example, markets have already declined about as much as we'd expect they would during a recession, but they've done so at an unusually rapid pace, making it too early to try to call for a bottom. And in fixed income markets, we could see default pressures rise, especially for hard-hit areas such as the energy and travel/leisure sectors.

We're not trying to make guesses about where market prices will bottom, but there are factors we are watching. Since this crisis is event driven and not a result of structural or financial problems, the critical sign to watch will be when we see a plateau in new COVID-19 cases. Once that happens, we will be better able to assess the related supply and demand shocks as well as provide more clarity on the corporate earnings outlook. Additionally, markets are looking for additional policy responses. Both Europe and the U.S. would benefit from fiscal stimulus (specifically targeted at hardest-hit businesses and displaced workers), and the Federal Reserve and its peers could still do more to expand their balance sheets and provide liquidity. Perhaps most important, people are looking for consistent and clear health policy guidance and global response coordination. Investors are desperate to see policy actions that curtail fear and engender confidence.

The economic data is also important to watch. China was the first major economy to experience an abrupt economic slowdown and should be the first to emerge from it. The data we have through February so far shows an unprecedented slowdown in economic activity, but March data should be better. While we know similarly-poor data is coming in the U.S. and Europe thanks to the impact of the virus and the associated countermeasures, we haven't seen it yet. We expect the data from March and April to be terrible. Only once the mitigation strategies like social distancing end will we get a full sense of the overall economic effect.

From a technical perspective, we're also looking for a decline in implied market volatility, narrower credit spreads and falling correlations between different asset classes. In our view, all of those factors will be associated with a broader recovery in risk assets.

WHAT IS THE OUTLOOK FOR OIL PRICES AND THE ENERGY SECTOR?

The oil price shock is coming from both weak demand and increased supply. And given the countermeasures in place to counteract the virus, energy demand levels aren't likely to pick up any time soon. We also haven't yet seen signs that oil producers such as Saudi Arabia or Russia are interested in reducing supply. As such, we expect the global energy sector to remain under extreme pressure and the risks of credit defaults from small and medium-sized companies are likely to pick up.

Amid the turmoil, there are some geographies and sectors that should benefit from the price shock. Emerging Asian economies are net oil importers, which could provide a tailwind to growth. Additionally, lower energy prices should benefit consumers in the U.S. and elsewhere when they are willing or able to start spending again.

WHAT WILL BE THE ULTIMATE IMPACT ON GLOBAL ECONOMIC GROWTH AND CORPORATE EARNINGS?

The short answer is no one knows. As a base case, the Organization for Economic Cooperation and Development in early March estimated that 2020 world growth will experience a -0.5% hit, reducing annual growth to 2.4% (the average world growth rate has been close to 3.5% since 1971). That forecast is probably too optimistic given what we have seen over the past couple of weeks. In the United States, we expect second quarter growth to plunge to between -2% to -5% (and possibly more) given all of the countermeasures in place. If we start to see the possible bottoming signs we discussed previously over the next couple of months, we could see a strong rebound as soon as the third quarter.

The corporate earnings outlook is similar and will be the key question that will determine how stock prices fare over 2020. Since interest rates are now so low, we don't think stock valuations will fall much more. In other words, capitulation through valuation doesn't seem likely. But stocks could fall further if earnings expectations fall sharply from here. Our collective sense is that the consensus "E" in P/E ratios remains too high. But how low will earnings go? We think first quarter results will mostly be OK, at least in the U.S. and Europe. Second quarter numbers are likely to be terrible across the board. After that, results will depend on how long and how serious this crisis lasts. If earnings turn out to be flat for all of 2020 (as some analysts are forecasting), that could imply that equity prices are undervalued at current prices and could climb modestly by the end of the year. If earnings shrink, however, the ceiling for stock prices may be lower.

If there is good news on this front, it's that the global economy and corporations entered this crisis in good shape. This doesn't look like 2007 when balance sheets were shaky and the financial system was undercapitalized.

WHAT MORE CAN (AND SHOULD) THE FED AND OTHER POLICYMAKERS DO AT THIS POINT?

Global central banks are running out of ammunition, but they will continue to do what they can to provide liquidity and ease monetary policy. Investors can expect more rate cuts, asset purchases, financing programs, forward guidance and regulatory relief. For its part, the U.S. Federal Reserve already stepped in last week to inject liquidity to help Treasury markets function and also today provided liquidity to non-bank issuers of commercial paper as they did in 2008. The size of their new asset purchases is also massive in scope. Since the Fed announced it would purchase Treasuries on Sunday, it has already bought $40 billion each of the last two trading days—this compares to a $45 billion-per-month rate during the most recent quantitative easing period. Finally, we could see the central bank enact further emergency measures with the assistance of the Treasury (as part of Section 13(3) of the Federal Reserve Act) that would allow the Fed to promote liquidity and guarantee loans in additional markets.

Critically, though, global central bank actions cannot meaningfully help address the spread of the virus, the collapse in energy markets, the supply chain disruptions or the destruction in demand. What is needed here is globally coordinated health care and social distancing policies that could include aspects such as widespread and free testing as well as fiscal policy initiatives that both help individual affected through expanded health care benefits and unemployment assistance and targeted industry-specific relief.

HOW SHOULD INVESTORS APPROACH THE MARKETS GIVEN ALL OF THE TURMOIL?

As we have been saying since the crisis first emerged, we continue to advocate that investors stay diversified and rebalance as part of their routine portfolio maintenance. In other words, if an investor was already planning to invest in equities or other risk assets, we see no reason to deviate from that strategy.

At the same time, our investment teams across global markets are seeing relative value shifting between and within asset classes. In our multi-asset strategies, for example, we are sticking with broad defensive positioning while also looking for ways to deploy new cash into tactical areas that may be undervalued. In equities, we're looking at companies with stable growth, healthy balance sheets and potential dividend growth. In fixed income, we prefer mostly higher quality investments (including municipal bonds) and we are focused on defensive areas of the public and private real assets and real estate markets. We also think it makes sense to continue looking at less liquid private equity and credit markets that can provide buffers during price shocks. In all cases, the opportunities we are seeing are idiosyncratic and fast moving, which speaks to the importance of selectivity, research and active management.

For more information, please visit us at nuveen.com.

Endnotes

Sources

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