Commentary
Markets

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What Just Happened? Part 2

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With some shocking economic data and poor asset class performance, a week on from our last update, markets are still firmly in crisis mode, albeit that we're beginning to see some nascent signs of improvement.

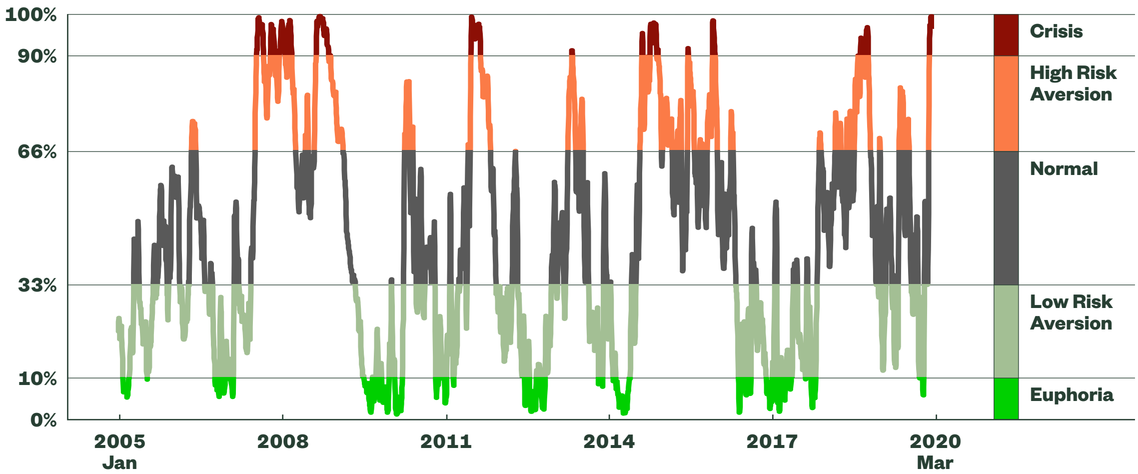
Investor Confidence

Our Investor Confidence Index, is one way of gauging the market's risk appetite, by looking at how the aggregate holdings of investors are changing over time.

Our Market Regime Indicator, shown below, takes another approach to identify the current market risk environment using forward-looking indicators. We believe the factors used to construct the indicator: equity and currency implied volatility and risky debt spreads, are good indicators of the current risk environment as they are responsive to real-time market impacts and in theory should include all current and forward views across all those markets. We combine these factors to create a single measure to identify one of five risk regimes: Euphoria, Low Risk, Normal, High Risk, and Crisis.

As you can see, we entered the Crisis regime in early March, and have been there ever since — But there are some tiny green shoots: The MRI is dropping ever so slightly from its highest level, as equity implied volatility (eg the VIX) and FX implied volatility have come off their highs.

Figure 1
Market Regime Indicator (MRI)
In early March 2020, the MRI entered Crisis Regime and has stayed there since



Source: As of 30 March 2020. The data displayed is not indicative of the past or future performance of any SSGA product. The portion of results through 31 March 2011 represents a back-test of the MRI model, which means that those results were achieved by means of the retroactive application of the model which was developed with the benefit of hindsight. Data displayed beyond this date is not backtested, but is still generated by the model referenced. All data shown above does not represent the results of actual trading, and in fact, actual results could differ substantially, and there is the potential for loss as well as profit.

Global Economy: The Data is Bad

We've talked before about the 3 Waves of Crisis —

1. The first wave is when people realise they have a problem and start discounting asset prices based on their changing expectations of how bad the problem could get.

2. The second wave is when economic data starts reflecting the scale of the problem.

3. The third wave is when corporates start discussing the impact of the crisis on their business models and analysts start incorporating them into their forecasts.

We are currently firmly in Phase 2 — The economic data is starting to show through with the bad PMI data and starkly terrible US jobless claims data from the last two weeks.

What should be clear though is that things will continue to get worse before they get better, as more and more of the effects of the forced closures and redirections of businesses and restricted movements of people feed through into economic data.

Asset Class Performance: Uniformly Negative with Two Exceptions

Moving on to asset classes, the chart on the following page shows the performance of select asset classes over the last month (in blue), and over the year so far (in green).

What is obvious is that over both these timeframes, asset class returns (all measured in their local currencies, or USD as a default) have been uniformly negative, with the exception of the Bloomberg Barclays US Aggregate Index, and Gold over the year to date. These have eked out positive returns of between 3 and 4%, respectively.

Clearly the largest drop has come in the oil price, which at time of writing is down over 50%, and with unprecedented volatility, seeing daily moves up and down of over 20% as the politics of the staring match between Russia and Saudi ebb and flow.

This collapse in the oil price came as a genuine black swan, and affected more than just equity indices — such as the UK's FTSE All Share (with its greater than 10% weight in oil & gas producers) — but also the US High Yield Index (which has a similar proportion of energy names.)

Figure 2

Asset-Class Performance

Markets suffered dramatic losses in February and March as investors came to the realisation that the coronavirus was not going to be contained within China

1 Month

YTD

Source: Bloomberg Finance, L.P. As of 31 March 2020. Past performance is not a guarantee of future results. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income. Performance returns for periods of less than one year are not annualised.

Factors: Defensives Still Outperforming

As we've highlighted before, there has been a really clear differentiation between factors this year with defensive factors outperforming at the expense of cyclical. This response was especially marked in Europe, where the Momentum factor has been the strongest year to date, ably supported by Low Volatility, Growth and Quality.

In each geography, the Small Size factor has suffered more than Value, but unlike Value, where once again, given a view that rates will stay lower for longer, it's hard to see the same rebound that we saw post-GFC in March 2009, we're more hopeful that the recovery, when it comes, will see more of a rebound to Small Size — although a lot depends on the extent of the effects of the forced halt to output and how much support smaller businesses might have received from their respective governments.

Bonds: Riskier Looking More Attractive

The Fixed Income market shows a very clear demarcation of risk and return as well. As we move up the risk spectrum, we're seing one-year returns drop and yields increase. Outside the US, we also see durations drop as risk increases, so on a risk-adjusted basis (yield per unit of duration), some of the riskier portions of fixed income are looking a lot more attractive than at the start of the year.

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