

Could the surge in market volatility signal the end of the current market cycle?



Last Friday, Russia surprised markets by refusing to the production cuts the rest of OPEC+ supported – cuts that were needed to stabilize oil prices in the face of the coronavirus-related hit to global demand. Saudi Arabia responded over the weekend by announcing an actual increase in oil production. This comes on the heels of an announcement by Italy effectively shutting down much of northern Italy.

How have markets reacted?

Markets have continued the coronavirus-related sell-off experienced over the last several weeks. Global stocks have continued their drop, as have sovereign debt yields. Oil prices saw a steepening of the oil price drop that began in response to expectations of lower demand as a result of the spread of the coronavirus. And on Sunday night, the 10-year Treasury yield fell to 0.318%.¹ We believe these developments will very likely impart new shocks to the global economy and financial markets – including another steep drop in the oil price, public concerns about the spread of coronavirus, and additional gyrations in global markets.

What can investors expect from Saudi Arabia's price war?

Saudi Arabia appears to have several goals in sight, including hurting U.S. shale oil producers, and reducing Russia's role and weight in the oil market and in OPEC+ as one of the world's leading oil producers and exporters. Saudi Arabia is better able to tolerate lower oil prices as the leading producer with national control of oil production via state-owned Saudi Aramco. (By contrast, Russia has many mainly private oil producers as well as Rosneft, a major, largely national oil firm.) In principle, Saudi Arabia may therefore be able to weather a longer downdraft in oil prices than Russia or private U.S. firms.

We foresee five potential effects of a steep fall in the price of oil.

- 1) An oil price cut would likely lead to lower stock prices for oil, gas, chemical, and trading companies.
- 2) Oil-producing emerging markets economies are likely to be hit hard, which may create concerns

over their budget deficit, balance of payment, and foreign debt – and consequentially, currency depreciation. Additionally, we'd expect a hit to utilities companies with tariffs linked to wholesale energy prices, as well as banks with exposure to energy producers.

3) Oil would become cheaper for importing countries and consumers.

4) Saudi Arabia and other major producers (including Russia, U.S. shale, and other OPEC+ members) would be negatively affected.

5) Financial conditions would likely tighten significantly, especially for high-cost producers and for those with significant refinancing or investment financing needs. (This includes U.S. shale as well as major national oil companies such as Pemex.) Credit spreads are likely to widen in these sectors and sovereigns, possibly quite steeply.

Monitoring the continued effects of coronavirus

In addition to the turbulence of oil prices, the surge in global coronavirus infections continues to wreak havoc on markets. As the virus spreads across continental Europe and countries implement extreme public health responses, we expect a further dent to public confidence, as well as further retrenchment in discretionary consumer and business spending.

Italy's situation – a lockdown of the northern part of the country – is especially notable because, like South Korea, the country has conducted extensive testing, and its case load and fatalities have risen significantly. Much of Italy's business is centered in the quarantined area; the Lombardy is a particularly important industrial region of northern Italy, as it includes the Milan financial center.

Governments in other countries have largely focused on encouraging "social distancing" and hygiene, as well as restrictions on international travel to help slow the spread of the virus. Hence, we would expect both global governments and the public to carefully monitor the public reaction in Italy, as well as the efficacy of these measures.

Is the current market cycle finally at risk?

Taking a step back, for years we've said that the current business and market cycle would not only prove to be the longest cycle on record, but that it would go on beyond that for far longer than most expected. While the cycle was old in age, the fundamentals in the credit market were sound. Aggregate credit growth was the weakest of any of the U.S. economic cycles on record, banks were well-capitalized, and U.S. corporations had taken advantage of the environment to borrow at historically low rates and to push maturities well out in the future. Thus, a recession did not appear to be in the offing, barring a major policy mistake somewhere in the world or an unforeseen, exogenous shock to economic activity.

Alas, the coronavirus and the oil market disruption may prove to be the exogenous shocks that end this elongated cycle. Global growth was already in a tenuous state following the weakness in economic activity resulting from the trade war uncertainty in 2019. The coronavirus-related disruption in economic activity came at an inopportune time. Compounding the problem is the oil supply flooding markets. Oil prices are plunging, an ominous sign for U.S. business investment and a troublesome sign for the U.S. below-investment grade credit market, which is heavily comprised of U.S. energy companies.

Our end-of-cycle dashboard signals are flashing, with long interest rates falling, the yield curve flattening meaningfully, energy prices collapsing, and high yield spreads widening meaningfully. It is currently painting a troublesome picture, which we are following closely. Is additional policy stimulus on the horizon?

The double-whammy of the coronavirus outbreak and the flooding of the oil supply (and resultant pressure on oil producers) is causing a dramatic reaction in equity, fixed income, currency, and oil markets – clearly, markets are responding to fear of a global recession.

We expect that data will get decidedly weaker, with a continuation of the extreme “risk-off” environment that has investors flocking to asset classes such as U.S. Treasuries, the yen, and gold amid an environment of heightened volatility. Barring the possibility of financial system instability, and assuming an appropriate monetary and fiscal response, we could be getting closer to a bottom.

While the coronavirus contagion could improve relatively quickly, it seems unlikely that is the case for the oil supply shock. 2014 to 2015 may well provide a useful recent historical benchmark, when Saudi Arabia also raised output to reduce oil prices in order to flush out U.S. shale, and to attempt to restrain Russian and Iranian influence in the Middle East and the oil market. At that time, global demand was also weak with China having suffered from a strong dollar following the taper tantrum. It took many months of diplomacy for the situation to improve. That said, the U.S. expansion was at an earlier stage and China was prepared to engage in a major fiscal, monetary, and importantly, credit stimulus to accelerate its own domestic economy.

Today, in contrast, the global and U.S. expansions are more advanced; the global growth shocks are less amenable to policy stimulus, especially monetary easing (since supply chain disruptions or decisions to avoid discretionary spending for health and safety reasons are unlikely to respond to stimulus directly), and the risk of cashflow constriction might raise the risk of a wave of defaults by highly leveraged firms (including in the U.S. shale sector).

In addition, another steep oil price fall in the context of fears of falling global growth and general final demand is likely to weigh on headline inflation and inflation expectations. The result is likely to be a further compression in bond yields, a reduction in “term premia” (the excess return normally required to hold long-term bonds as opposed to rolling over short-term bonds), and pricing in of further rate cuts.

Until last week, a strong case could be constructed for the Federal Reserve (Fed) and other major central banks to hold their fire and wait to see how the global economy and efforts to contain coronavirus would fare. Now, however, if curves continue to invert (and especially if financial conditions continue to tighten), the chances are rising significantly that the Fed will validate market pricing of further rate cuts, as well as resort to renewed quantitative easing if required. There is an increased possibility that central banks will consider using even more experimental monetary policy such as helicopter money, especially if fiscal support does not materialize.

The reality is that rate cuts will have very little effect at this stage; what is more important is the provision of liquidity. We would add to that list the provision of fiscal stimulus.

Fiscal support for small- and medium-sized companies and other affected areas have been announced in several countries; we would need to see more if conditions continue as they are now

or worsen. Italy should also be watched carefully to see how the government fares with its fiscal response, and how the response in the EU and eurozone unfolds. (Italy's sovereign spreads have been volatile and initially widened out when coronavirus concerns first surfaced in recent weeks.)

General fiscal stimulus may be necessary; the downswing in activity may be more protracted and gradual than the V-shaped recovery that is hoped for in the world at large. This seems to already be materializing in China. Many countries lack the spare treatment and hospitalization capacity (or the ability to mobilize resources) that China has. As a result, self-quarantine and restraints on discretionary spending may result in a more gradual, protracted slowdown. We worry there is a lack of confidence in markets that countries will provide adequate fiscal stimulus. Recall that the U.S. Congress narrowly approved Troubled Asset Relief Program funding during the global financial crisis, and that central bankers have lamented in recent years that many governments have not provided adequate fiscal stimulus.

Summing up the current situation

In conclusion, it's important to note that the fundamentals of this cycle were sound – but the coronavirus is an unexpected, exogenous event that may prove very disruptive to economic activity.

Can the market situation get worse? Clearly yes, especially given the panic that is out there (both in the market but also the general reaction to the increasing flow of dramatic headlines and the lack of confidence in governments to provide the appropriate policy response). Just how bad could it get? Our worst-case modelling calls for a global recession, but we believe this is a relatively low-probability scenario.

We believe we'll know a bottom is near based on virus data, not economic data – specifically, when we see a clear peak and decline in the daily run rate of non-Chinese cases and deaths.

Finally, we must reiterate that we will get beyond this. Stocks have been trading very cheap to bonds and with each passing day, new opportunities are emerging. Lower oil prices and lower interest rates will be supportive for the consumer in due time. Ultimately, we believe that we will look back at this as a recession within a long-term secular bull market.