Coronavirus Contagion

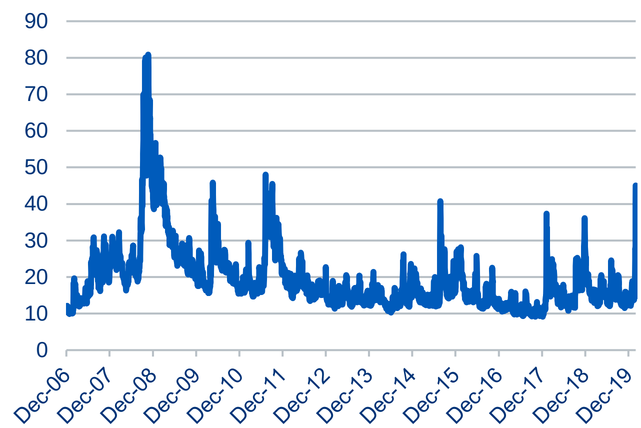
Concerns that the Coronavirus will severely disrupt global trade and output, and perhaps provoke a global recession, have hit equity and commodity markets hard. Safe haven assets, in contrast, have soared, sending yields on U.S. Treasuries and other sovereign government bonds to all-time lows. The uncertainty surrounding the extent and nature of the threat to health and prosperity posed by the Coronavirus has compounded the market reaction. Advanced economy central banks have indicated their readiness to mitigate the impact of the virus, while China and other emerging economies in Asia are planning fiscal measures to forestall a severe downturn. We are monitoring events closely to assess the implications for markets and our already underweight exposure to risk assets.

Contagion, Valuations, and Fear

In the best of times, making decisions under uncertainty requires humility, balance, and the mastery of reason over emotion. The uncertainty created by the Coronavirus Disease 2019 (COVID-19) presents a particular challenge as it provokes fear, the emotion most likely to dominate reason. In reaction to the relentless spread of the virus, the VIX index of implied volatilities for U.S. equities, also known as the fear gauge, has spiked in recent days, although it remains well below the highs of the Great Financial Crisis of 2007-09 (Exhibit below).[1]

The market reaction is not wholly irrational; the Coronavirus has highlighted the vulnerabilities of global supply chains and the other interdependencies of globalization. Moreover, when the Coronavirus emerged, many global equity markets were richly valued following the outsized gains of 2019. From these lofty valuations, global equity markets have suffered successive large declines in recent days as investors have reacted with increasing alarm.

VIX – Fear Gauge Flashes Yellow
Source: Bloomberg.



Global Equity Market Contagion

The speed of the equity selloff has been particularly striking. The current correction is the most rapid on record. The U.S. equity market, for example, which had been trading at all-time highs following its 31% gain in 2019, is down about 15% from its high. It has declined about 10% so far in 2020, returning to price levels last seen in October of last year (Exhibit below).

Equity markets outside of the U.S. have also been hard hit. European equities, led by the U.K. (down 16%), have fallen by about 12% in 2020 as recession fears have gripped a continent whose economies were already showing signs of sluggishness. Asian developed and emerging equity markets have also seen sharp falls this year, with markets in Japan, Hong Kong, and Korea down about 11%, 7%, and 14%, respectively. Other regional bourses with strong trade links with China have also suffered. Despite being the epicenter of the contagion, local Chinese equity markets, paradoxically, have actually risen in 2020, with the China A-share market enjoying a modest gain.

[1] Data are as of 12:00 p.m. EST, February 28, 2020. Returns are all in U.S. dollar terms.

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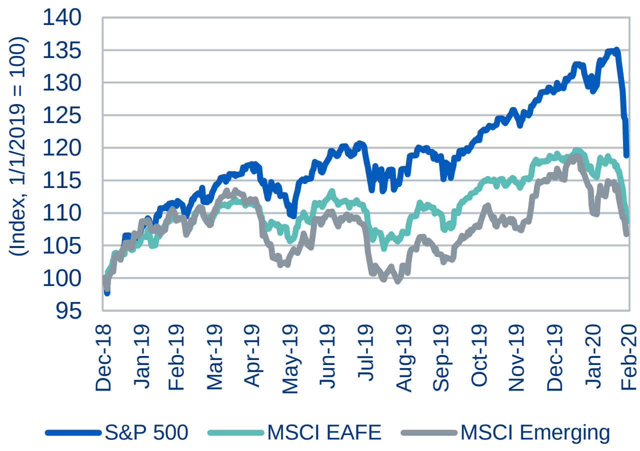
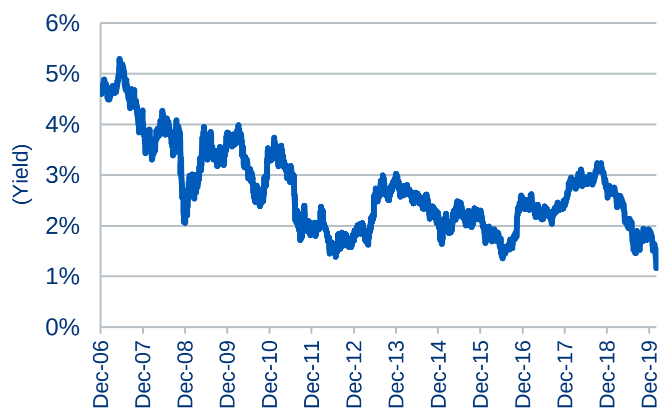
Global Equities Fall After Stellar Gains in 2019
Source: Bloomberg.



Flight to Safety Pushes Yields to New Lows

Safe haven assets have benefited from rising risk aversion. The yield on the 10-year U.S. Treasury hit an all-time low today of 1.15% (Exhibit below). Real yields on 10-year TIPS have fallen to a new low of -30 basis points, and inflation expectations declined to 1.5%, reflecting fears that disinflationary forces will be unleashed by a significant downturn in activity. Long-dated U.S. Treasuries have been the best performing asset so far this year. Markets now anticipate that the Fed will cut rates four times in 2020, up from only one or two cuts expected just a few weeks ago. In the credit markets, long-dated investment grade bonds have also performed well, while high yield bonds have suffered relatively muted declines. Outside of the U.S., other safe haven bond yields have also dropped, with the yield on the 10-year German bund falling to -30 basis points. The stock of global bonds priced to have negative nominal yields has increased to $14 trillion, 23% of the total.

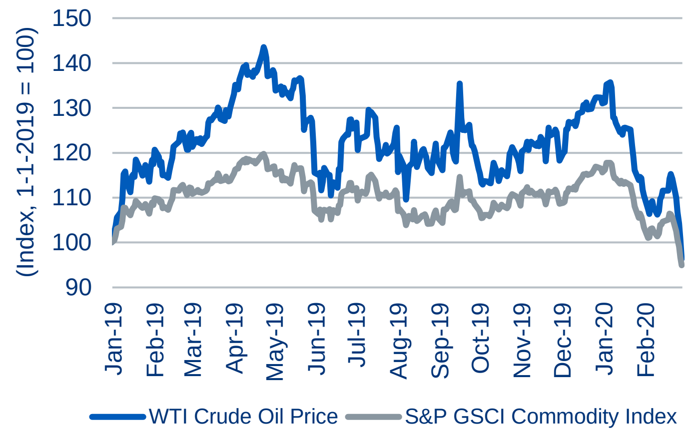
Flight to Safety Sends 10-year Treasury Yields to Lows
Source: Bloomberg.



Commodities Fall on Recession Fears

Fears of a global downturn have roiled commodity markets. Crude oil (WTI) is trading at about $45/bbl, down 27% in 2020, despite calls by Saudi Arabia for large output cuts. Copper and other base metals are down 9-11% this year. Gold, rather surprisingly, fell sharply today, reversing its gains for the year. The GSCI commodity index is down 18.3% so far this year (Exhibit below).

Commodity Prices Tumble
Source: Bloomberg.



Portfolio Positioning

We remain convinced that a coldly analytical, disciplined focus on divergences between market prices and our estimates of fair value represents the most effective way to manage investment portfolios. Going into the recent market turmoil, we had positioned our portfolios to defend them from expensive valuations. We retain a small underweight to equities, while favoring the relative valuations available in non-U.S. geographies and value styles. In fixed income markets, we retain a solid U.S. duration underweight coupled with a small underweight to credit. We also carry a small tactical allocation to non-U.S. bond markets to benefit from attractive real yields and idiosyncratic credit opportunities. We maintain an underweight to real assets by keeping TIPS and real estate below policy weight. We balance these underweights with above-policy allocations to hedge funds and cash.

Please be assured that we are monitoring the evolving Coronavirus contagion closely, maintaining our disciplined focus on valuations, communicating with our managers continuously, and keeping a keen eye on portfolio liquidity. We also stand ready to implement Strategic's established and tested contingency plans to allow us to continue to serve our clients seamlessly despite business disruptions. We will inform you immediately of any significant changes in our outlook and positioning. Please do not hesitate to contact us with any questions or concerns.