

Quick Take

TAKE 5 VIEWS



March 24, 2020

Experts share latest developments on coronavirus, spiking oil prices and their impact on the markets

In this quickly changing world, we want to present you more updates from our subadvisors. We look at three critical areas: actions taken by the Federal Reserve, the energy sector, and the high yield bond market.



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The Fed Speaks Loudly And Carries A Big Stick

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The U.S. Federal Reserve (Fed) just announced (on Sunday, March 15th) a massive and well-crafted policy response to the coronavirus shock.

A number of commentators have quickly criticized it or dismissed it, arguing that no amount of monetary stimulus can get people back to the malls or the restaurants when they are worried about contagion. Some argue that for the same reason, fiscal policy will also be toothless. We could not disagree more, for the following reasons:

1. The measures announced by the Fed—and the fiscal measures under consideration—will help businesses stay open and will reduce the number of layoffs. The people who, thanks to the Fed or the government, keep their job, or have more cash in their pockets thanks to fiscal policy, will still not go to the mall, but they will shop online, they will order food for home delivery, they will not cancel their mobile phones. All this has a positive effect on spending today and through the contagion period.
2. Once contagion is contained and extreme social distancing stops, hopefully within 4-6 weeks, the economic recovery will be faster and stronger if

more businesses have been able to stay open and more people have kept their jobs through the worst of the crisis.

3. This will be a temporary shock. Monetary and fiscal policy do not need to get people back to the shopping mall or on a flight, they need to keep them employed and spending on other things while the crisis lasts, and ready to go back to the mall or the airport when it stops. Monetary and fiscal policy are not expected to boost production in the factory facing weaker demand, they are aimed at helping the factory stay open until demand recovers.
4. Finally, putting in place extraordinary monetary and fiscal measures today is what will allow us to have a strong, hopefully V-shaped recovery once contagion is contained. As the health emergency recedes, having extremely supportive monetary and fiscal conditions already in place will make a massive difference.

LEGG MASON
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The Energy Sector

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The global energy sector is facing a period of lower realized prices, uncertainty, and rising leverage.

This year is off to a tumultuous start to say the least, with volatility increasing in commodity markets. Leaving 2019 there was a semblance of stability creeping in that was welcomed by commodity markets. Oil demand growth was still present albeit at a slower pace, OPEC

and Russia were continuing to maintain supply cohesion and non-OPEC supply growth was expected. This essentially placed a cap on prices but management teams were still able to lower price decks. Following the 2015/2016 rout, managements made real strides in operating efficiencies (to lower break-even prices), repairing balance sheets, extending out maturities, bolstering liquidity and target managing to within cash flow—essentially providing a runway.

Roll forward to early 2020, we have already had two unforeseen events impacting oil markets in very short order, leaving the market in uncharted territory:

- A global demand shock due to the coronavirus/ COVID-19: starting in China, this has evolved into a broader issue as the virus continues to spread across the world. It now threatens to adversely impact global economic growth and oil demand growth forecasts.
- A global supply shock due to the breakdown of the relationship between Saudi Arabia and Russia: this has resulted in Saudi Arabia cutting official sales prices, signaling a price war.

The combination of these shocks means the global energy sector is facing a period of lower realized prices, uncertainty, rising leverage and likely shrinkage with the larger, lower cost, better-capitalized companies surviving. What complicates matters are the unknowns around the magnitude and duration of these shocks.

Energy issuers have been particularly impacted by recent market volatility, and not aided by the latest OPEC move. Rating agency commodity price assumptions are in the process of being downgraded, with S&P already acting and taking 2020 Brent/WTI/Henry Hub prices to \$40/\$35/\$2, respectively (from \$60/\$55/\$2.25); taking 2021 Brent/WTI/Henry Hub prices to \$50/\$45/\$2.25 (from \$55/\$55/\$2.50); and taking 2022 and beyond to Brent/WTI/Henry Hub prices to \$55/\$50/\$2.50, (from \$55/\$55/\$2.70). Consequently, ratings downgrades are likely.



High Yield Bond Market Update

Lord Abbett

High yield bonds, as measured by the ICE BofAML U.S. High Yield Constrained Index, posted negative returns over the year-to-date period as fears surrounding COVID-19 and oil price volatility led to a severe risk-off environment. Over the period, higher quality tiers of the high yield market outperformed lower quality tiers. The 'CCC' segment sharply underperformed the broader market, largely due to the selloff in the energy sector, overall investor sentiment and headwinds to price discovery in this lowest rung. High yield spreads started the year at 360 basis points (bps) OAS, and reached a low of 338 bps in mid-January. In late February, concerns surrounding the impact of COVID-19 on global growth intensified as the coronavirus spread globally.

In response to the coronavirus outbreak, the U.S. Federal Reserve (the "Fed") cut the federal funds rate by half a percentage point on March 3rd. This move marked the first emergency cut by the Fed since December 2008. While stocks initially rallied in response to the surprise rate cut, any gains were erased soon after. Treasuries rallied as yields plummeted during the last week of February and early March as the market grew increasingly concerned of the implications surrounding COVID-19. The 10-year U.S. Treasury yield slid below 50bps heading into the week of March 9th, and the 30-year U.S. Treasury rate closed below 1%, which were 80-100bps below previous floors.

Markets received an additional catalyst for volatility in early March with the breakdown in the OPEC alliance and a price war between Saudi Arabia and Russia. Oil prices collapsed by more than 20%, stocks declined sharply and credit spreads widened over 100 basis points to an OAS of 668 bps in one session. As of March 12th, high yield spreads widened to 742 bps, which is nearly 400bps wider than year-end levels.

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Certain illnesses spread rapidly and have the potential to significantly and adversely affect the global economy. An outbreak of respiratory disease caused by a novel coronavirus designated as COVID-19 was first detected in China in December 2019 and subsequently spread internationally. The transmission of COVID-19 and efforts to contain its spread have resulted in international, national and local border closings and other significant travel restrictions and disruptions, significant disruptions to business operations, supply chains and customer activity, event cancellations and restrictions, service cancellations, reductions and other changes, significant challenges in healthcare service preparation and delivery, and quarantines, as well as general concern and uncertainty that has negatively affected the economic environment. These impacts also have caused significant volatility and declines in global financial markets, which have caused losses for investors. The impact of this COVID-19 pandemic may be short term or may last for an extended period of time, and in either case could result in a substantial economic downturn or recession. No guarantee or representation is made that investment objectives and/or opinions stated will be achieved. Each specific client's or investor's experience may vary.

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