FAQ: Coronavirus and Market Volatility

The coronavirus outbreak has continued to be a source of volatility in financial markets as more countries have reported cases of infection. In this Q&A, we provide a brief update on developments and discuss potential scenarios.

Why have markets become more volatile recently?

We believe recent volatility is being driven by a broad repricing of risks as a result of the rapid spread of COVID-19 cases outside of China.

For much of February, financial markets appeared to price in a central scenario in which the impact of the virus was relatively temporary. China took aggressive measures to contain the outbreak and support the economy, creating the potential for a rapid recovery in activity. Data provided support for this scenario as the growth rate of new cases in China began to slow and closely watched data on Chinese power consumption, passenger traffic and property sales showed signs of improvement. In a scenario where the virus was contained with limited impact, investors likely began to look ahead to the stimulus effect of China's easing measures.

Markets now appear to be pricing in a higher probability that the coronavirus impact will be more severe and prolonged. The key drivers of this repricing include a surge in reported infections in Italy, South Korea, Iran and other countries. On February 26, the World Health Organization noted that there were more new cases reported from countries outside of China than were reported from China. In the United States (US), confirmed cases remain low but technical problems with the initial test for the virus have limited the number of tests, and a senior official with the Centers for Disease Control and Prevention (CDC) noted the potential for severe disruption to everyday life. In Japan, the government has recommended that all schools close until April.

As the flow of news related to the virus has worsened, markets have repriced to reflect lower expectations for global growth and corporate earnings. The repricing has been very broad, with little evidence that investors are differentiating by sector or by individual companies at this stage.

What are the potential scenarios from here?

We see three main scenarios:

1) An increase in the flow of negative news related to the virus, which would likely lead to further repricing of risk;
2) Stabilization in the growth rate of new reported cases, which could lead markets to reverse at least a portion of the recent moves; and
3) A decline in the growth rate of new cases, which could lead investors to conclude that containment measures are succeeding, and refocus on the potential for a snapback in activity given stimulus from lower interest rates globally and China's aggressive measures to support the economy.

Markets currently appear to be pricing in a mix of the first two scenarios. For example, the Chicago Board Options Exchange Volatility Index (VIX Index), a measure of implied volatility[1] in the S&P 500, has risen sharply but pricing suggests daily implied volatility of less than 2.5%, compared to levels around 5% to 6% during the 2007-2008 global financial crisis.

Meanwhile, interest rate markets are pricing in roughly 75 basis points[2] of easing by the US Federal Reserve (Fed) and longer-term interest rates, including the US 10-year yield, have moved to new record lows. Despite these moves, the demand for hedges against further declines in rates remains strong. We think this is particularly notable given that the Fed has indicated that negative policy rates would be among the last measures it would consider in a future easing cycle.

What is GSAM's investment strategy in this environment?

Strategy varies across our investment teams but we have not made significant changes to portfolios. In some cases, individual teams have taken steps to reduce risk.

In **Fundamental Equity** portfolios, we focus on the long-term, emphasize quality, and maintain balance in our portfolios. As a result, we have been able to respond to the opportunities the market has made available in this more uncertain and increasingly volatile environment. We have a heightened awareness of the risks that exist in companies 1) exposed to travel (airlines, cruise lines, hotels, gaming, logistics, shipping, and luxury goods), 2) exposed to China manufacturing and consequent supply chain disruptions, 3) with higher leverage (that may not be able to weather softening demand), and 4) are more cyclically exposed, especially where demand is more globally driven (energy); and those that have benefitted, especially companies exposed to online consumption and parts of healthcare. Looking ahead, we believe the sharp price adjustments are creating an opportunity to selectively add to our higher conviction ideas. We seek to maintain a balance in our portfolios and will be clinical in our decision making.

In **Fixed Income** portfolios, our goal is to have balanced portfolios that may produce returns across a variety of scenarios. As a result, we have not made significant changes to portfolios and we continue to see value in holding credit risk, balanced by exposure to duration. While credit has underperformed, the rally in government bonds has helped to cushion the impact on portfolio performance in multisector portfolios where we have implemented this strategy. We see less value in mortgage-backed securities (MBS) given the potential for rising mortgage refinancing activity, and we are cautious on emerging market currencies due to the general risk-off[3] tone in markets. We see more value in areas such as investment grade and high yield corporate credit, which have seen significant underperformance due to investor de-risking.

In **Quantitative Investment Strategies** (QIS) portfolios, idiosyncratic or unpredictable events such as the coronavirus outbreak are reflected in our stock selection models through a few mechanisms. First, returns will flow through our faster moving signals, such as our Themes & Trends signals. These may change which market themes we view as best poised to potentially outperform. Next, as investors reposition their portfolios and commentators opine on events, our Sentiment factors will integrate the changing market attitudes into our investment views.

In **Money Market** portfolios, we have modestly extended duration to hedge against some of the more severe outcomes and the growing likelihood that the Fed will cut interest rates. Although it will take time for the Fed to assess the economic impact of the virus, policymakers may elect to cut rates at one of the upcoming meetings to offset tighter financial conditions.

What is the likelihood of a recession? How should investors think about the outlook from here?

The economic outlook is uncertain but at this stage we continue to believe a recession is unlikely in the US or global economy. Economic activity was on an improving trend as recently as January, and we think growth is likely to remain resilient in a scenario where the impact from the coronavirus is primarily contained to the first half of the year. We have revised down our outlook for China's growth for 2020 to 5.2% from 5.8%, but believe the policy response and signs of stabilization in activity should limit further downside.

From a market perspective, the S&P 500 has just experienced its first 3% moves of 2020. While this is highly uncomfortable, it is not unprecedented (the S&P 500 experienced six moves of 3% or more in 2018). Consequently, we continue to believe the most appropriate strategy is to remain invested and remain focused on strategic asset allocation, with an eye toward risk management, as episodic volatility may continue.

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[1] Implied volatility is the expected volatility in a stock's return derived from its option price, maturity date, exercise price, and riskless rate of return, using an option pricing model such as Black-Scholes.

[2] One basis point is equivalent to 1/100th of a percent.

[3] Risk-off is an investment setting in which price behavior responds to and is driven by changes in investor risk tolerance. Risk-off refers to changes in investment activity in response to global economic patterns. When risk is perceived to be high, investors have the tendency to gravitate toward lower-risk investments.

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