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Market turbulence follows coronavirus and oil price war

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The worsening coronavirus outbreak and oil price war have sharply increased financial market turbulence. The number of coronavirus cases is expected to rise sharply over coming weeks in North America and Europe based on the views of respected epidemiologists. Even if fatalities remain low, essential measures to contain the virus are expected to disrupt global supply chains and weaken consumer confidence. Compounding the economic shock from the coronavirus is Saudi Arabia's oil price war, which comes at an inopportune time for the global economy. Ramping up oil supply to boost market share and displace US shale producers has increased credit risk in the high yield energy sector.

The global sell-off has increased stress in several areas:

- **Stock market volatility.** Circuit breakers have curbed trading in US markets following strong selling pressure. Equity markets have now entered bear market territory after declining by more than 20%. The sell-off in US stocks on Thursday by 9.5% was the worst day for the S&P500 since 1987. The S&P TSX declined by 12.3%, the worst day since May 1940.
- **Treasury yields acting unusually.** High-quality bonds typically move against equities in risk-off scenarios. On Thursday, US Treasury yields traded higher during the session even as equities sold off. These movements point to potentially distressed or liquidity-constrained investors closing trades or raising cash. This market action in part prompted the Federal Reserve to intervene in money markets with unprecedented liquidity operations (see below).
- **Inflation market pricing-in unusually low inflation.** The rapid decline in bond yields in the last two weeks implies a breakeven or expected inflation rate below 1% in the US for the next 10 years, which has not been priced-in by markets since 2009.
- **Credit spreads widening sharply.** High yield corporate credit spreads jumped to over 700 basis points this week compared to about 350 basis points in mid-February. In the energy sector, high yield spreads more than doubled to over 17% since mid-February, a level last seen in 2016. Widening corporate spreads increase funding stress for companies.
- **Money markets under pressure.** For the third time in four days, the US Federal Reserve announced measures to increase its lending into the critical US repo market in which investors exchange high-quality bonds for short-term cash. The Fed stands ready to inject over $5 trillion as needed in short-term loans held in weekly auctions until April 13. These short-term liquidity injections are important to ensure that short-term funding remains liquid for investors and other borrowers.

Policymakers are expected to take additional actions to help calm market turbulence by easing central bank rates further, ensuring funding liquidity and delivering fiscal stimulus that support vulnerable industries and workers.

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Looking ahead, long-term investors should continue rebalancing portfolios to their long-term asset mix. The coronavirus and oil price shock are unlikely to affect long-term earnings growth of the corporate sector and long-term interest rates, which largely drive the long-term fair value of equity indexes. In that context, several important factors to consider include the following:

- **Investment horizon.** Cheaper stocks after the recent sell-off result in a higher long-term expected return. For this reason, investors with long-term financial objectives should stay invested if possible. However, volatility may remain elevated in the short term.
- **Portfolio rebalancing.** For investors with a long-term asset mix, regular rebalancing can help to reduce total fund drawdown in periods of market stress and potentially contribute to a more rapid rebound. After a prolonged multi-year bull run, equity allocations in some portfolios could be higher than long-term targets. Other investors who were closer to their target asset mix in early 2020 may now be underweight in equities following the recent sell-off. Rebalancing to a neutral asset mix position can help maintain a well-balanced portfolio during volatile periods and position the portfolio for the recovery phase.
- **Fixed income and portfolio diversification.** As government bond yields reach low levels, they may eventually become less effective in diversifying multi-asset portfolios because rates will have less room to fall. However, the low yields of other high-quality government bonds suggest US and Canadian sovereign yields still have room to fall in distressed economic scenarios. Bonds still play a critical role in a well-balanced portfolio to diversify equity risk and provide liquidity.

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