THRIVENT ASSET MANAGEMENT

Drilling down on the market sell-off

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Historic volatility in global financial markets has continued with European equity markets down more than 10% and U.S. stocks once again triggering "circuit breakers," with losses of more than 8% on Thursday. Credit markets, such as corporate bonds, also are down significantly.

What is causing the continued sell-off?

Markets are becoming increasingly concerned that the impact of the COVID-19 virus and efforts to contain its spread globally will lead to a global recession. Markets have also been underwhelmed by the response of governments and central banks to limit the economic and financial damage.

The World Health Organization has declared the outbreak a global pandemic as COVID-19 has spread to more than 110 countries. While new cases have slowed significantly in China, the growth of cases outside of China has been increasing rapidly.

Governments and private enterprises are seeking to mitigate the transmission of the virus by limiting activity. For example, Italy, which has seen a sharp spike in cases, has shut down all retail shops except for grocery stores, pharmacies and a few others, in addition to limiting travel and large gatherings. The economic impact is substantial.

Similar actions have also taken place in the U.S., including cancellation of many events and conferences, closing of schools and college campuses, a ban on travel to and from Europe, and suspension or postponement of the major professional sports leagues.

These measures, while helping to slow the spread of the COVID-19, lessen economic activity. This decline in economic activity impacts the expected earnings of companies, which are reflected in stock prices.

Uncertainty continues

Presently there is a high degree of uncertainty over the future course of the virus and the extent and duration of the economic damage. This uncertainty fuels the high level of volatility in markets.

- Markets have been disappointed with the level of coordinated monetary policy and fiscal stimulus so far within the U.S. The Federal Reserve (Fed) has cut rates and further cuts are likely along with other measures to support market functioning. However, fiscal stimulus plans are currently unclear.
- Equities have fallen sharply, but this decline is from record levels. While we have entered a "bear market" with the S&P 500® down more than 20%, we are at levels last seen in early 2019, just a little more than a year ago. Valuations are becoming more attractive, but uncertainty over future earnings persists.
- Within fixed-income markets, risk premiums in the form of yield spreads to U.S. Treasuries have increased significantly. The widening of credit spreads has driven down bond prices, particularly for energy companies and travel-related industries, such as hotels and airlines. Credit markets are pricing in an increasing likelihood that companies within heavily impacted industries will need to restructure.
- There are signs of financial market stress, such as large bid-ask spreads (the difference between selling and buying prices) in corporate debt markets and even declining liquidity in normally-liquid markets, such as U.S. Treasuries.

Calming measures

So, what is needed to help calm markets?

- Steps by the government to mitigate the impact on the economy and markets, including fiscal and other measures to support both households and businesses impacted by the economic slowdown.
- Further steps by the Fed to provide liquidity to the markets, including rate cuts and liquidity facilities. For example, on Thursday the Fed increased purchases of longer-term U.S. Treasuries to support market functioning along with providing liquidity to U.S. dollar funding markets.
- An end to the oil price war triggered by Saudi Arabia and Russia, which has caused oil prices to collapse.
- Greater certainty over the severity of the COVID-19 outbreak, particularly a decline in the growth rate of new cases. Such a decline has already taken place in China.

We expect market volatility to continue but ultimately decrease as markets gain increased clarity on the global pandemic and the economic fallout. That would allow markets to find a level that appropriately prices in the macroeconomic risks.

It's important to remember that the U.S. economy was structurally sound heading into this crisis. Unemployment was low, household finances strong and there were few signs of cyclical excesses.

This crisis will pass with time as others have before, and markets will begin to price in a recovery. Long-term valuations are likely to be more attractive, but it will be important to consider the basic market fundamentals, such as earnings prospects, interest rates, debt, and liquidity.

Headwinds will remain, including difficulty gauging the level of earnings recovery along with more leveraged corporate balance sheets. However, economic tailwinds are likely, including low interest rates and inflation, low energy prices for consumers and supportive monetary policy from central banks.

In summary, volatility and uncertainty is likely to persist for a period of time. More downside is possible, as is a potentially quick market move upward as the uncertainty lessens. While investors should be prepared for these possibilities, it is important to put short-term volatility in the perspective of a long-term financial plan.

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