Thrivent Asset Management view on market sell-off

March 9, 2020

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After an historically volatile week in financial markets with stock indices ricocheting daily from severe losses to sharp gains, and U.S. Treasury bond yields collapsing in a flight to quality, global markets have opened the week in full panic mode. European stock markets have traded down over 7%, while Asian markets are down 3-5%. In the U.S., stocks immediately traded to levels that triggered market mandated "circuit breakers."

These trading rules are put into effect to blunt the effect of a cascade of falling prices that can feed on itself in illiquid and disorderly markets. The first level is a halt of trading when the market is down 7%. After that, there is a 15-minute "cooling off" period before trading resumes, as we saw earlier today.

If stocks reach a 13% downside limit on the day, a new 15-minute halt will ensue. As of now, the first halt has held when trading resumed. Meanwhile, U.S. Treasury bond prices are soaring in a flight to safety, causing yields to trade at yields below 1.00% across the curve. What has happened?

In short, the market is now paying attention to epidemiologists and public health experts who are gaining a much better grasp on the rapid virulence of the COVID-19 epidemic, and not to central bankers or politicians who, up to now, have not. In the past week, the statistical models that public health experts use to forecast the exponential growth of viral outbreaks appear to be coming to fruition. The number of countries reporting COVID-19 infection are rapidly increasing, while the total number of worldwide cases and deaths are multiplying at exponential rates. Italy has now taken the extreme step of quarantining entire areas in the northern part of the country. Here in the U.S., Seattle has become a so-called "hot spot" of infection and is beginning to take steps to try to suppress further transmission. In short, this is now clearly not a short-term health crisis but is one that needs a rapid and coordinated response.

As the exponential statistics of epidemics are applied to the COVID-19 outbreak, the realization of the potentially severe impact this may have on economic activity has gripped investors. As precautionary measures are taken by government entities, corporations and individuals, recession is now a much higher probability, if not a foregone conclusion in some countries.

Currently, it is impossible to know the full impact of the COVID-19 outbreak both from a public health perspective and from an economic perspective. However, clearly the environment is profoundly changed from just a month ago. Here are a few things to consider:

- There is increasing evidence that this outbreak cannot be contained globally, but it can be suppressed if strong action is taken. China has demonstrated this with its very assertive response. Currently, the growth rate of infection in China has declined considerably. Although experts believe the level of incidence may increase again once the broader population goes back to work, it is encouraging that China shows signs of stabilizing. However, it should be kept in mind that China, as an authoritarian government, has the political and social structure that allows for draconian measures to suppress the virus. Most of the rest of the developed world does not have this type of structure, making suppression more difficult.

- The virus is just now moving rapidly into the rest of the world, including the U.S. As of now, there has been disappointing evidence concerning how well-prepared many countries are for this type of public health crisis. In the U.S., although $8.5 billion has been quickly authorized to fight this problem, it will take time to put together a coherent and effective plan to deal with the outbreak.

- Economic activity will be severely hurt in the short-term, and this damage could lead to an outright recession. However, after a record 10-plus years of healthy economic expansion, a downturn caused by such an exogenous shock should not be surprising. Fortunately, in the United States the consumer came into this shock in very good shape, with historically high employment, rising incomes and relatively low debt. This contrasts to the vulnerable position the U.S. consumer was in prior to the financial crisis.

- Oil prices have crashed as a result of both the realization of sharply lower economic activity and the increasingly acrimonious battle between OPEC—led by Saudi Arabia—and Russia. Saudi Arabia has refused to cut oil production as it makes a play to maintain its power in world oil markets. The collapse in oil prices, if it persists, will severely damage the financial health of the shale industry in the U.S. This could lead to bankruptcies and layoffs that could reverberate through the banking system, the high yield bond market and the domestic economy.

- The financial markets may take time to stabilize. The ripple effects of sharply-curtailed economic activity, collapsing oil prices, large near-term declines in stock prices and investor anxiety will be significant. High degrees of near-term volatility are nearly assured, while potential further equity market declines are very possible, if not probable. Investors need to be prepared for this, stick to their long-term plan and refrain from panic. Two old adages come to mind here; "the horse is out of the barn already" and "this too shall pass."

- When this crisis winds down, and they always do, it will be important to consider the basic market fundamentals of long-term earnings prospects, inflation, interest rates, debt and liquidity. Earnings will be very difficult to gauge for a few quarters. If not, the balance of 2020 and corporate debt levels are relatively high.

- These factors will be serious headwinds to a swift recovery in market prices. However, a strong and long-lasting countervailing tailwind may come from exceptionally low inflation and bond yields, coupled with central bank policies that are sure to pump whatever liquidity is needed into the system to help stabilize the capital markets. Finally, money market funds have ballooned to $3.7 trillion in assets, up 32% in two years, and are assured to vault even higher. The bond market is pricing in 0% short term interest rates. As money market yield collapse back to 0% again, this money will eventually look for higher returns.

In summary, this situation is unlike others we have seen previously in the financial markets, in that it is driven by uneconomic forces. Typical responses to financial crises such as lowering interest rates and enacting fiscal policy initiatives, although long term potentially helpful, cannot change consumer and investor behavior in the face of increasing uncertainty caused by a public health situation.

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