Market update

Vise of volatility tightens

As if the further spread of coronavirus (COVID-19) wasn't enough for equity and fixed income markets to contend with, the collapse in crude oil prices has exacerbated volatility and heightened economic uncertainties. The S&P 500 has fallen 19 percent from its mid-February peak, government bond yields have dropped to record lows, and crude oil is down almost 50 percent year to date.

Markets are having a difficult time gauging the potential knock-on effects of the coronavirus and crude oil rout for economic growth as well as corporate sales and profits, and the impact of funding for businesses. Following are thoughts about key aspects of this challenging period from RBC economists and strategists, and the Global Portfolio Advisory Committee.

Coronavirus: Some silver linings

Developments surrounding the spread of the virus—both positive and negative—are moving fast.

- On the positive side, RBC Global Asset Management Inc. Chief Economist Eric Lascelles points out, "Within China, the improvement is truly remarkable." Rates of new infections have plunged, and as tens of thousands have been declared virus-free, the number of those currently infected has receded to less than 19,000 of the almost 81,000 originally infected. Lascelles wrote, "China—responsible for 77 percent of the world's cases—has managed to control the disease and is now in the process of restarting its economy. This must surely bode well for the rest of the world."
- Furthermore, he said, "It is extremely heartening that South Korea also appears to have brought its outbreak under tentative control. The number of new cases in Korea peaked at over 800 new cases per day, but is now down to less than 400 daily and steadily falling."
- Outside of Asia, infection rates are accelerating, which is a concern to us. Containment and quarantine efforts have ramped up meaningfully in Italy, which should help to arrest the spread of the virus going forward in this country. Infection rates may continue to accelerate in other nations, including in the U.S., as reporting and testing improves. There could be a need for stricter containment efforts in North America and Europe before we see the rate of infection begin to slow in these regions.

A call for the Fed to "get on with it"

While the equity and crude oil markets have stolen a big share of the headlines, it's the fixed income market that has absorbed historic moves.

- On Mar. 9, the entire Treasury yield curve—from short-term bills all the way out to the 30-year bond—was below 1.0 percent as investors worldwide piled into the relative safety of U.S. bonds. The yield on 10-year and 30-year Treasuries plunged as low as 0.3137 percent and 0.6987 percent, respectively, midday during the trading session. The same day, the German 10-year yield briefly cascaded down to -0.907 percent.
- Considering how low Treasury yields have fallen, RBC Capital Markets, LLC Chief U.S. Economist Tom Porcelli said, "nobody should be surprised" if the Fed comes out and cuts rates by an additional 100 basis points to the zero percent to 0.25 percent lower bound. Even though he thinks such a rate cut "will have virtually zero economic impact" amid coronavirus fears, if cutting by this magnitude allows the Fed to demonstrate it is providing maximum help and places a greater burden on the federal government to step in with more fiscal spending, then the Fed "should get on with it."

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Porcelli added, "Bridge loans for corporates and small businesses perhaps managed by the Fed (through the banking system) and backed by the Treasury would be a start." (*Chop off the tail of uncertainty*)

- The Trump administration's announcement on Mar. 9 that it will meet with lawmakers to discuss providing assistance to Americans who are suffering financially due to coronavirus risks and to businesses that are being seriously impacted, including small businesses, is a step in the right direction, in our view.

Credit market in focus

Beyond much-needed fiscal stimulus and movements in sovereign bond yields, we are closely monitoring developments in the corporate bond market.

- After a multiyear trend of declining corporate bond yields, various gauges of borrowing costs rose rapidly in recent days. This is notable given this increase in borrowing costs is a function of investors demanding greater compensation above government bond yields for the risks they are taking (aka larger risk premiums), given government yields have recently declined to record lows.
- Companies with weaker credit profiles and those in certain industries facing specific challenges, such as energy and leisure, have been most impacted for now. But should other companies encounter sustained difficulty in accessing credit on reasonable terms, it could have significant implications for the broader economy and may imply higher borrowing costs for companies looking to refinance maturing debt.

Oil: A protracted struggle?

The crude oil market has suffered a series of setbacks so far this year that is either directly or indirectly linked to the coronavirus outbreak. This contributes to economic risks in many oil-intensive countries.

- First, crude oil weakened when the coronavirus began to raise risks for global economic growth.
- Second, it slumped more when competing proposals by Saudi Arabia to further cut production due to coronavirus-related economic risks, and by Russia to extend the existing production limits, failed to gain support at the recent OPEC+ meeting. Without an extension or new deal, the production limits that had been in place will expire on Mar. 31.
- Third, crude oil dropped even further when Saudi Arabia, in response to the OPEC+ meeting impasse, sharply lowered its oil prices in an attempt to gain market share, and announced plans for a significant production increase. This development tipped oil over the edge, pushing WTI crude oil down nearly 25 percent on Mar. 9 to $31.13/barrel (bbl), the biggest single-day percentage decline since the 1991 Gulf War. Brent fell to $34.36/bbl. These oil benchmarks began the year at $61.06/bbl and $66.00/bbl, respectively.
- Neither the Saudis nor the Russians have slammed the door shut on cooperating, but our analysts are skeptical. RBC Capital Markets' commodity team wrote, "While OPEC leadership retains hope that the price collapse will be a catalyst for a reconciliation between the two oil heavyweights, President Putin may not quickly capitulate. We fear that it could be a protracted struggle, as Russia's strategy seems to be targeting not simply U.S. shale companies—but the coercive sanctions policy that American energy abundance has enabled." (*Letter from Riyadh: Aftershocks*)
- Our research sources believe that the breakeven oil price for OPEC nations is over $50/bbl, suggesting that OPEC producers would likely be running a fiscal deficit at current oil prices. We expect most oil producers around the world will have to significantly scale back production and capital expenditure plans.

Equities likely grappling with a "growth scare"

Lori Calvasina, RBC Capital Markets, LLC head of U.S. equity strategy, believes the U.S. equity market is in the midst of a "growth scare"—where the market fears U.S. recession risks, but a recession ultimately is avoided.

- Growth scares are nothing new for this expansion cycle that began in 2009. They occurred in 2010, 2011, 2015–16, and the second half of 2018. The peak-to-trough declines for the S&P 500 during the four prior growth scares ranged from 14.2 percent to 19.8 percent. (*Global Insight Weekly: Fear factor*)
- Downside for the equity market could be more pronounced if economic conditions worsen. Calvasina wrote, "If we are wrong, it will be because stocks are starting to anticipate a recession, where the average and median drop has been 32 percent and 24 percent, respectively, since the 1930s. That kind of drop would take the S&P 500 into the 2,300–2,600 range."
- Thus far, the sentiment indicators for institutional and individual investors are not yet showing signs of capitulation, according to Calvasina. While both have turned bearish in the past few weeks, neither of them has reached extremely bearish levels, which are typically contrary indicators for the market. (*Capitulation still hasn't been seen*)

- Calvasina maintains her $174/share earnings estimate for the S&P 500 in 2020. However, she acknowledges that the coronavirus headwinds could result in a lower outcome of $169/share. If a mild recession were to occur, the estimate could come down to $167/share. (By way of comparison, S&P 500 earnings are pacing at $163/share for 2019, according to the consensus estimate.)

Our bottom line

The health of the U.S. economy—specifically, whether it avoids a recession or succumbs to one—plays a crucial role in the outlook for global equity markets.

- Before the coronavirus began to pressure financial markets, the anticipated directions for the global economy and earnings growth were positive. The risks to our macroeconomic views are now biased to the downside as the outbreak and the related crude oil headwinds should result in slower activity. The question is both for how long and by how much.
- At this stage, Lascelles believes the U.S. may suffer one quarter of negative growth due to the coronavirus headwinds but should be able "to squeeze out a modicum of economic growth in the adjacent quarters thanks to its higher natural rate of growth." Thus, a recession would be avoided.
- If a recession doesn't materialize in the U.S. this year, most stock markets should be able to meaningfully climb from the current correction levels by the end of 2020, in our view. However, the probabilities of a more adverse economic outcome are higher than when the year began.
- We will continue to evaluate our stance on the equities and fixed income markets in the days and weeks to come depending on how the risks evolve.

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