Investment Weekly

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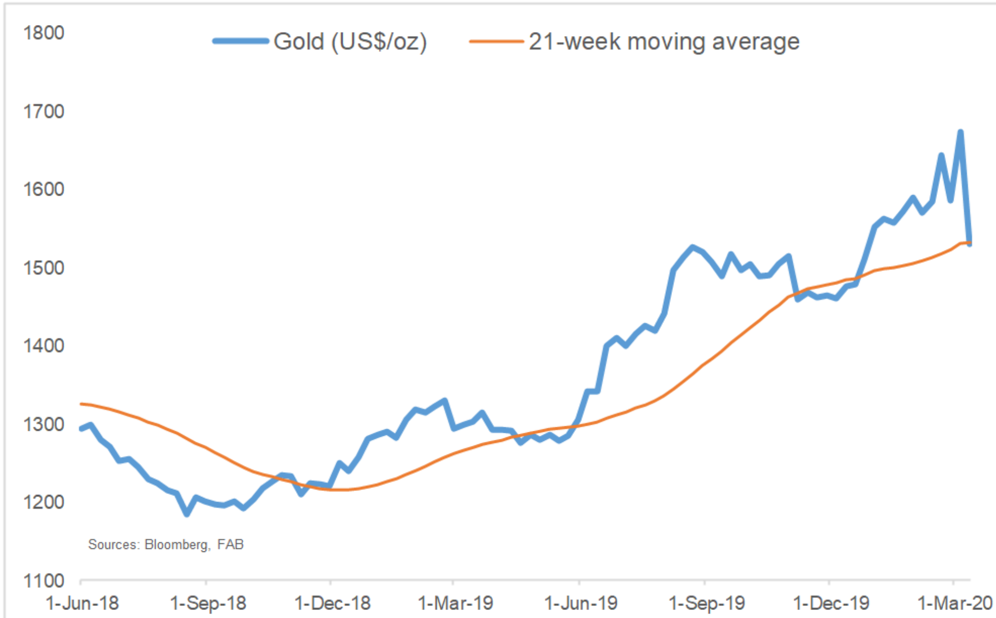
Official policy interventions start to calm financial markets

- ♦ **US stock market ends the week with a strong rally after policy statements are positively received.**
- ♦ **Historic volatility seems to be triggering deleveraging and emphasizes the need for quality assets.**
- ♦ **The US Federal Reserve has intervened in money markets to correct short-term liquidity concerns.**
- ♦ **The Fed starts buying long-term bonds again, officially restarting quantitative easing program.**
- ♦ **US and China say they will add their strategic petroleum reserves at these lower prices.**



Most periods of high volatility in financial markets began as a result of leverage being unwound, or due to excessive valuations. The 2008 Global Financial Crisis happened after investors and institutions made excessive leveraged investments in mortgages. When that had to be unwound it triggered a domino effect that brought the entire world into a recession. Similarly, in 1998, Russia's default on its debt caused an unwinding in the leverage of what was at the time the world's largest hedge fund, Long Term Capital Management, and the US financial system nearly collapsed.

This time, while the trigger has been the rapid spread of a new coronavirus strain from China, the violence of the market sell -off suggests there are large amounts of leverage being unwound very quickly, creating a self-feeding spiral. The speed at which investors have liquidated positions in stock funds suggests a fire sale. According to the Wall Street Journal, investors pulled US$47.4 billion from global stock-focused mutual funds in the three weeks ended last Wednesday. A correction in gold prices last week at the same time as the S&P 500 fell offered further indication that margin calls and fire sales are increasing the market volatility.

When the value of securities held by leveraged investors falls, they are faced with margin calls. In these situations, they often have to sell the most liquid asset, preferably the one that has previously rallied the most. In fact, gold prices dropped in the immediate weeks after Lehman Brothers filed for bankruptcy, setting off the domino effect that led to the Global Financial Crisis. Once margin call sales subsided, gold rallied.

The market activity of the past two weeks has all the hallmarks of a similar situation. Gold had gained 29.1% in the year ended 9 March, 2020. As some diversified investors seemingly took profits to meet

The recent drop in gold prices suggests some investors were selling to meet margin calls

margin calls, gold prices fell nearly 10% last week. Palladium, a favourite among hedge funds, had its worst week in more than a decade, falling almost 30%.

The other haven, US Treasuries, did not drop as much, but yields for the 10-year note still rose to 0.96% from a low of 0.45% at the start of the week. The performance of US Treasuries last week probably offers proof that part of the violence of the sell-off of the past two weeks was driven by margin calls and deleveraging activity too.

Once margin calls have been paid, lenders have to park the proceeds somewhere. Given the general fear, banks are likely to buy US Treasuries, helping to push their prices up. At the same time, mortgage investors have probably continued to buy long-dated Treasuries and swaps (which mirror Treasuries) to hedge for potentially higher home loan refinancing activity, which reduces the average life of mortgage portfolios.

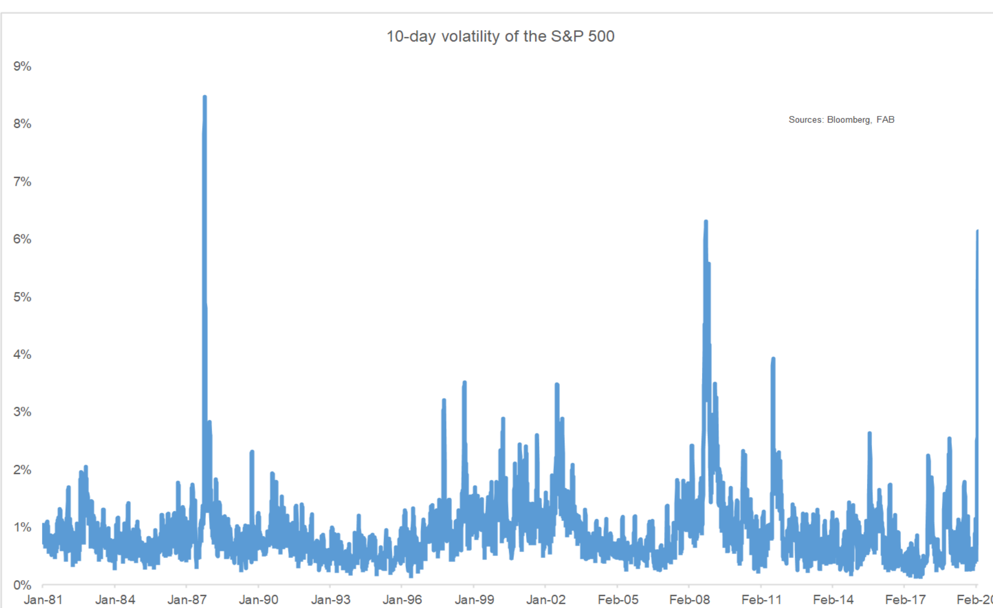
Again, that also creates a self-feeding spiral. The yield on the 10-year US Treasuries is used as the benchmark for fixed-rate home loans in the US, so when it drops, mortgage rates fall too and refinancing activity increases. That, then prompts more hedging by mortgage investors, pushing yields further down. An indication that mortgage investors hedging was part of the reason why US Treasury prices had rallied so much in the past two weeks is in the fact that swaps were leading Treasuries and trading at lower yields than the bonds themselves. Usually swap yields are higher than those of Treasury notes because the derivative contracts have an added layer of risk in the counterparty issuing them.

These kinds of spirals are hard to break and have been exacerbated this time because of the structure of financial markets. The use of exchange-traded funds (ETFs), some leveraged, now dominates trading. According to one study index funds own more than half of the US stock market, for instance. These funds allow instant liquidity but when investors start to sell them and the managers need to reduce their portfolios they cannot always find buyers for the securities they hold. That forces them to sell some securities at discounts, pushing the whole market down further.

The fact that ETFs have been part of the sell-off is evident in the discount at which these funds are trading. Some of the largest equity ETFs have traded at their highest discount to net asset value since they were listed. The net asset value should represent the market value of the securities held by an ETF, but when too many people are selling their holdings the market price of the fund tends to fall below that net asset value. However in normal market conditions the two values should once again converge.

The risk here becomes that some of these funds are leveraged and may not meet redemptions fast enough. That happened with some leveraged ETFs that allowed investors to create short positions on the VIX volatility index in February 2018, when the S&P 500 suddenly plunged. This time, the first victims have started to show in the oil space. Wisdom Tree last week announced the liquidation of two leveraged oil exchange-traded products (an ETF that is slightly different as it allows some structuring). The funds used swaps to emulate the moves in oil prices and the sudden collapse of last Monday triggered a forced liquidation of their positions.

The US stock volatility in the past 10 days was one of the highest in 40 years



The recent price weakness that led to the collapse of these exchange-traded products is not surprising given the events of the last few weeks. Brent crude prices dropped 24.1% on Monday after Saudi Arabia announced that it was going to start producing near capacity, despite a sharp slowdown in global demand. The decision came in the wake of an OPEC meeting two weeks ago, in which Russia refused to agree to further output cuts, as the nation felt that the curbs the group had implemented since 2016 had done more to reduce OPEC's share of the global market than control prices. Oil stabilized later in the week amid news that China and the US intend to use the opportunity of multi-year low oil prices to add to their strategic petroleum reserves. While that may help slow the price drop, the supply and demand mismatch could continue because end-demand for crude is weakening.

Saad Rahim, the CEO of Trafigura, an important oil trading company, said on Friday he expected oil demand to see the steepest drop in history. His forecast resonates with the International Energy Agency (IEA), which three weeks ago said it expected global annual oil consumption to shrink for the first time since the Global Financial Crisis. The IEA then estimated supply would outpace demand by some 500,000 barrels this quarter. However, that assessment considered only the Chinese lockdown. As the rest of the world closes its borders and tells people to stay home, that forecast has become obsolete at best.

There are still very few numbers to show the true impact of the coronavirus on oil demand, but the volume of oil processed by China's largest oil company, Sinopec, in February, was 24.4% lower than in

January. It was also the lowest in two years. If that were to be extrapolated to the US and Europe, which were moving into lockdown mode last week, oil demand could drop by some 8 million barrels/day. US oil demand had already been dropping, with the International Energy Agency estimating that Americans consumed 18.3 million barrels/day in the week ended 6 March, compared to 20.9 million barrels/ day in the last week of December.

Meanwhile, Iraq, Nigeria, Russia, Saudi Arabia and the United Arab Emirates are expected to increase production by as much as a 4.5 million barrels/day, according to Bloomberg. The two elements point to excess oil supply in the range of 10-12 million barrels/day, in line with the number that Mr. Rahim from Trafigura suggested last week.

To be sure, the true picture of oil demand will only start to become apparent when inventory data for the US and Europe (which usually comes with a two-week delay) is released this Wednesday. As stockpiles increase, oil prices could continue to stay under pressure.

While President Donald Trump initially celebrated the lower oil prices, his announcement on Friday that the US would take advantage of lower prices to rebuild its strategic reserves suggests he is trying to help put a floor under crude prices. Cheaper gasoline is good for the American consumer, and could soften some of the impact of the coronavirus, but it also could put many shale oil companies in Texas, North and South Dakota out of business. That could impact the economies of these states, since the energy industry employs more than 157,000 people in the US, according to the Bureau of Labor Statistics.

Hence, President Trump is involved in a difficult balancing act of keeping oil low to spur more consumer demand, while softening the drop to avoid a spike in unemployment within the energy industry that could deal a blow to the virus-weakened US economy.

Stock investors seemed to recognize that potential collateral damage last week. The announcement that Russia and Saudi Arabia were opening the spigots last weekend was part of the driver for the 7.6% drop in the S&P 500 on Monday. Indeed, that day the S&P 500 Energy sub-index fell 20.1%. Similarly, President Trump's announcement that he was filing the strategic reserves pushed the same index up by 8.8% on Friday, while the S&P 500 ended that day 9.3% higher.

The support from the reserve replenishment, however, may be limited. The US Strategic Petroleum Reserves maximum capacity is 714 million barrels and it currently holds about 630 million barrels. Assuming oversupply in the ballpark of 10 million barrels/day means that filling the US Strategic Petroleum Reserve would correct the market imbalance for less than eight days. In other words, until the OPEC reduces output oil prices could continue to suffer.

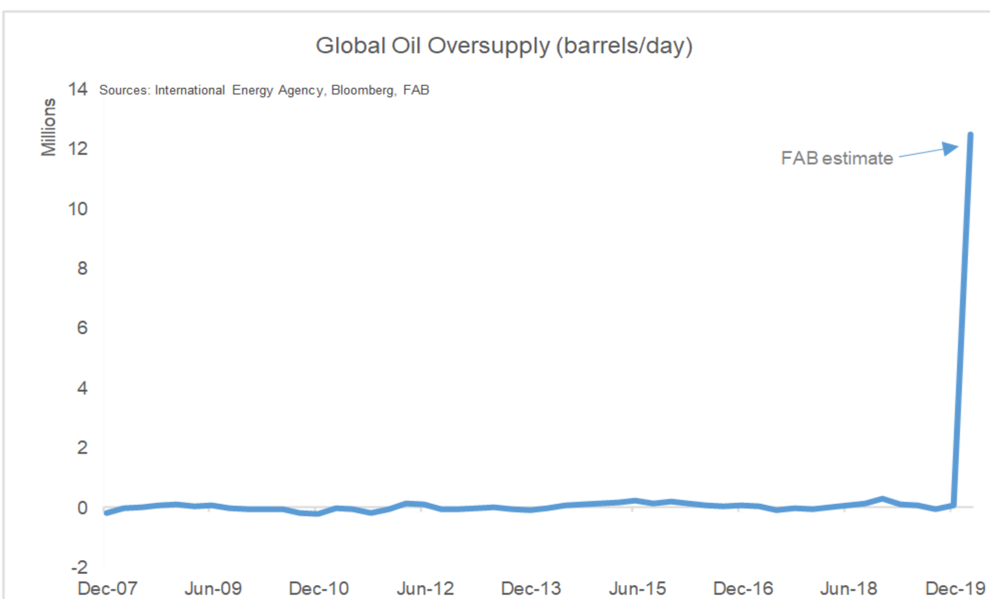
That could represent a challenge for US high-yield because of the weight of energy sector in the asset class. Bonds from this industry represent about 4.5% of the IBoxx US Corporate High-Yield index, the fourth biggest weight in the measure.

The potential for rising unemployment in the energy sector, as well as the impact on airlines and retailers of the recent lockdowns could further depress consumer and business confidence. These effects could slow down the US economy, which helps explain why the Fed has already cut interest rates by 50 basis points and could cut even more this Wednesday.

The central bank is also increasing its quantitative easing efforts. The key for the world economy to turn around, however, will be fiscal spending, and this is why markets rallied so much after President Trump announced such measures on Friday. Fiscal stimulus takes a while to be felt in the economy, but eventually, once the virus spread subsides, the impact of monetary and fiscal easing will help world growth bounce back.

For most equity investors it appears too late to sell, especially since the moves in markets have been unprecedented. Rather, properly diversified investors should have benefitted from that diversification, and should make sure that the underlying fundamental quality of their positions remains high.

More oil from OPEC when global demand is falling could lead to temporary oversupply



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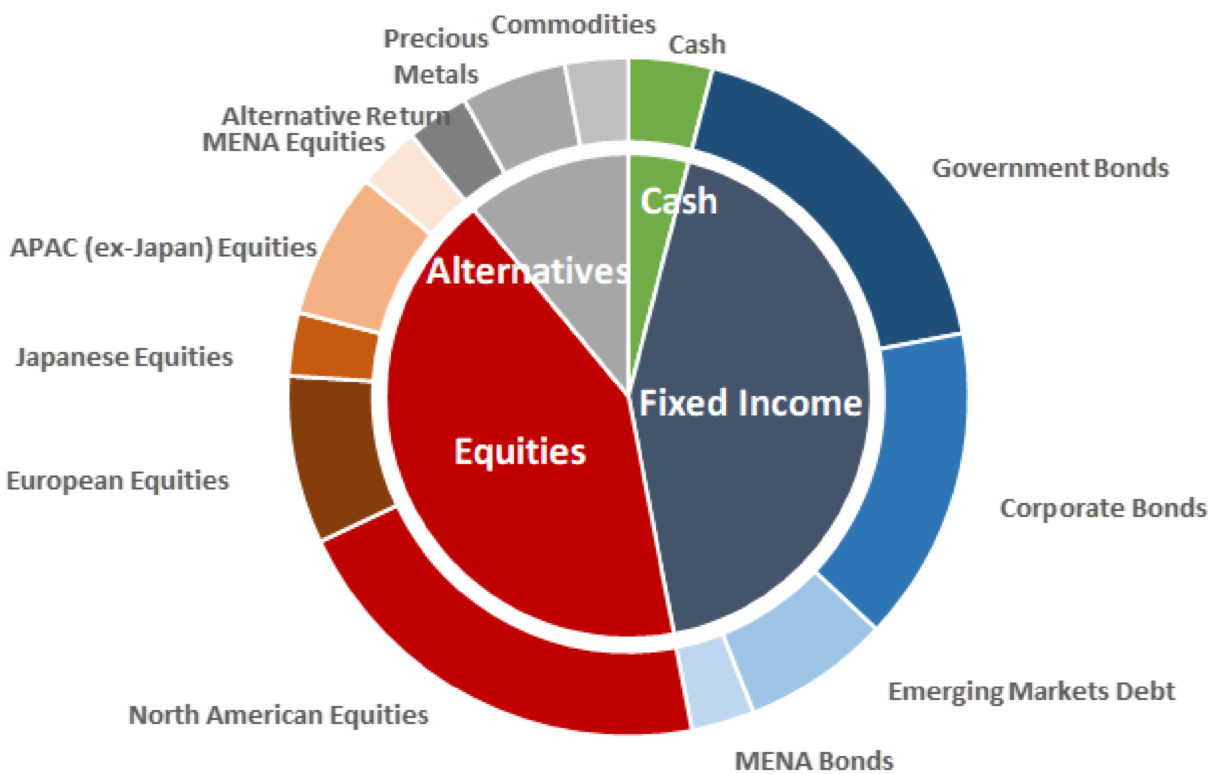
Current Tactical Asset Allocation



Asset Class	Positioning	Detail
Cash	Neutral	After allocating more cash to investment grade corporate debt
Fixed Income	Overweight	Moving to slightly overweight after adding overweight to EM dollar debt and corporate investment grade bonds
Equities	Overweight	Rotating US exposure to defensive stocks
Alternatives	Underweight	However, overweight on precious metals specifically

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