

Between Fear and FOMO

by

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Over the past few months, investors have had to contend with three concurrent forces: a pandemic which is still not well understood; a sudden stop of the global economy; and the fastest and most substantial policy support ever seen. A good way to frame these three factors is that policymakers (central banks and governments) have been going to extraordinary lengths to bridge the gap in economic activity caused by the coronavirus-induced shutdown.

This had led many commentators to point to a large divergence between financial markets and the real economy. As Goldman Sachs recently noted, "most institutional investors have been stunned by the juxtaposition of the sharpest GDP contraction on record with a 36% market rally, as have we." Given that every policy response should be framed as helping to weather this period of depressed activity, the real surprise isn't the divergence itself, but that these policies have, so far, worked so well.

Some have been critical of central banks for providing a "backstop" to markets and suggesting that it is not possible to "fix a debt problem with more debt." However, the issue with this argument is that this is not a debt problem; it is a public health crisis. High levels of corporate debt presented a key vulnerability, so it is no surprise that central banks, having learned important lessons from the global financial crisis, acted quickly and aggressively to provide liquidity.

While the strength seen in credit markets has been unsurprising given the direct central bank support, equity market strength has been more surprising and has recently had an air of fear of missing out (FOMO). Interest rate cuts by the Federal Reserve at the beginning of March did not initially support financial markets, but the 23 March announcement that the central bank would be buying corporate bonds marked the bottom for risky assets.

There were severe dislocations in financial markets in March, but this support helped the yield on 7-10 year corporate bonds fall from a peak of 4.63% to 2.60% at the end of May. A lower cost of debt for corporate borrowers helps to support earnings and equity market multiples, but more importantly, it short circuited what could have been a vicious cycle of higher borrowing costs and defaults and instead we had a virtuous circle of refinancing which helped to restore confidence.

The equity market recovery has had three distinct stages, with interesting underlying dynamics at a sector and company level. The initial recovery was due to the monetary policy support described above. The second stage, in April and early May was characterised by tentative economic optimism that fiscal policy would help cushion the economic slowdown. There was a high degree of dispersion, with relative winners (e-commerce, grocery and technology) leading the market. The third phase came towards the end of May as economic activity picked up and the more economically sensitive sectors, such as travel, leisure and financials, embraced the rally.

An interesting aspect to the last few months is the role played by retail investors. By many measures, retail investor activity is at the highest level since the dot-com boom in 1999. Quarantined, devoid of entertainment, such as sports, and in receipt of government stimulus cheques, over 2.1 million Americans have opened brokerage accounts at the three largest platforms so far in 2020. In contrast, the last stock market cycle, which ended in 2007, never saw a textbook "euphoria" end to the bull market, perhaps because of the toll the housing market weakness took on the middle class.

Retail volumes are small relative to the overall market, but even relatively small volumes are capable of having a disproportionate impact. For example, Bernstein's airlines analyst recently wrote "renewed retail interest... is undoubtedly putting pressure on shorts," meaning that short sellers were forced to buy back the shares they had sold. However, their conclusion was that retail buying does not fully explain the share price recovery and that "the reality is data points have been improving and are likely to continue to improve as the economy reopens".

Equity flows from institutional investors have been muted due to fears around the virus and prolonged economic weakness, together with a lack of earnings guidance and stretched valuations. The depth of the recession means that this is poised to be the shortest recession ever, but sustaining the recovery will likely require the US government to provide additional support to small businesses and extend unemployment insurance that is due to expire at the end of July. Assuming this happens, with the Fed "not even thinking about thinking about raising rates," any good news on the virus front may lead to less fear and even more FOM O.

Sources: Goldman Sachs, Bernstein, Bloomberg

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