Where do stocks and bonds go from here?

Weekly Market Compass: The monetary and fiscal response to the coronavirus crisis so far has resulted in a mixed outlook

Mar 30, 2020 | Kristina Hooper, Chief Global Market Strategist

In last week's blog, members of Invesco's Global Market Strategy (GMS) team in Hong Kong, Italy, London, Tokyo and New York shared their on-the-ground insights of the fight against coronavirus from a health care, monetary, and fiscal perspective. Today, we take a deeper dive into the potential implications of the pandemic on US stocks and bonds, as well as the GMS team's view of asset allocation considerations.

What technical indicators can help determine if the US equity market is getting closer to a bottom?

Talley Léger (New York): In a challenging market environment like this, I believe investors should employ technical analysis, which can help inform timing decisions around major market turning points long before the economic data do. Indeed, the stock market must bottom before a new business cycle can begin. Here's a comprehensive list of tactical indicators that offer an optimistic view that we may be near a market bottom:

1 **The Chicago Board Options Exchange (CBOE) Volatility Index (VIX).** Extreme investor fear has typically coincided with major market lows. The VIX, which is commonly known as the "fear gauge," has hit its highest percentage increase of the cycle and in its history, which is positive from a contrarian perspective. Since 2008, we've seen four equity volatility spikes above 70%.[1] Encouragingly, the returns on the S&P 500 Index were positive for the 12-month period following each episode (excluding the current experience), with a median return of 8%.[1]

2 **The CBOE equity put/call ratio.** This indicator measures seller positioning relative to buyer positioning. A ratio greater than 1 indicates more sellers than buyers and usually aligns with big market bottoms. The put/call ratio recently hit its highest level since 2008, when markets were in the depths of the Great Recession and Global Financial Crisis, which means that today's pessimism is overwhelming.

3 **The percentage of New York Stock Exchange (NYSE) stocks above their 200-day moving average.** This is a gauge of breadth, or lack thereof in this case. Today's low percentage reflects weak breadth and an extremely oversold condition, which is constructive, in my view.

4 **The S&P 500's deviation from its 200-day moving average.** The stock market has fallen below its 200-day moving average to a degree not seen since 2008/2009, 2002, and 1974.

5 **The US Economic Policy Uncertainty Index.** This index – which is based on a daily news-based search for the words "economic policy uncertainty" – recently hit its highest level in history. However, I believe that the US Congress' coronavirus stimulus package should ease uncertainty from this record high and help stocks further along the bottoming process. To further reduce uncertainty and aid this process, the global fiscal response needs to become coordinated and forceful.

6 **The 1987 crash versus the 2020 coronavirus crash.** This cycle-on-cycle comparison is lining up well so far, in my view. The S&P 500 Index fell over 30% from peak to trough in both crashes, followed by double-digit rebounds from the initial lows.[2]

On the other side of the coin, however, is a list of tactical indicators that are signaling the potential for further weakness in share prices ahead:

7 **The American Association of Individual Investors (AAII) Sentiment Survey.** The percentage of bearish minus bullish respondents has gotten negative but hasn't become cataclysmic yet. A bull-bear spread of -30% or less would suggest an approaching seller climax, but we're not there yet.

8 **The slope of the US Treasury yield curve.** The yield curve – or the difference between 10-year and 2-year government bond yields – is a signal from the fixed income market that the economic outlook is either getting better or worse. The curve has steepened somewhat, which is good, but it has usually been much steeper near significant lows in stocks.

9 **The US stock-to-bond ratio.** This ratio – a measure of investor risk-off positioning – shows that stocks (weak) and bonds (strong) are behaving like the economy is already contracting. While much of the coming fundamental damage is getting priced in, this ratio hasn't turned yet.

10 **The US cyclical-to-defensive ratio.** This indicator – a measure of investors' defensive posture – shows that the economy-sensitive sectors of the market (consumer discretionary, energy, financials, industrials, information technology, and materials) have remained understandably out of favor.

11 **US coronavirus cases.** Virus-related uncertainty could continue to weigh on stocks until the number of cases peaks.

Putting it all together, near-term chaos can create long-term opportunities for patient investors. We're starting to see the kind of despair that kills old bull markets and gives birth to new ones. To be clear, bottoming is a process, but indications of excessive caution in the marketplace suggest savvy investors should start looking for opportunities to be contrarian when others are fearful.

What is the US bond market telling us?

Tim Horsburgh (New York): US fixed income assets staged a marked reversal last week by rallying after an almost unprecedented decline in prices during the first three weeks of March. The Federal Reserve's forceful intervention on March 23 – with essentially open-ended quantitative easing and a raft of programs to help support various markets – has gone a long way to ease fears of a breakdown in market functioning. Similarly, while more targeted to end consumers to mitigate a demand shock, the fiscal stimulus signed by President Donald Trump on March 27 has also helped ease fears that the sudden stop in many economic activities would prove calamitous for even healthy and well-funded credits. Bid/ask spreads have tightened and, importantly, new deals and transactions are still getting completed.

We believe the recent dislocation has opened opportunities for investors seeking attractive entry points in fixed income. While an economic recession seems almost assured at this point, bonds won't suffer equally. The Fed's support will not be able to prevent genuinely distressed credits and companies from going bankrupt. We still favor looking higher in the quality spectrum for some of the best potential reward at this point in the cycle.

Even though spreads likely peaked last week for investment grade bonds, in our view, highly rated credit still looks attractive because it will likely be better able to withstand the coming wave of defaults and bankruptcies associated with even a moderate recession. High quality municipal bonds may also offer opportunities given still-high spreads over Treasuries. Municipal bonds have also historically defaulted at lower levels than many corporate bonds of similar quality. We expect mortgage-backed securities and structured credit to also do well as spreads tighten. The Fed's decision to intervene in some form in all of these markets should also add an additional tailwind to performance.

High yield bonds, on the other hand, will likely prove more challenging for investors. With the asset class (represented by the Bloomberg Barclays High Yield Index) having an approximately 10% weight to energy[3] and generally lower quality balance sheets, there will likely be more price declines and defaults in the future as the recession takes hold. Valuations in high yield are starting to look attractive from a historical standpoint, but with fundamentals deteriorating, it will take time before high yield defaults peak.

While dislocations are likely to persist for some time in the fixed income market, the worst is likely behind us in terms of liquidity fears now that the Fed has stepped in. We believe investors should consider adding to high quality fixed income to potentially take advantage of above-average spreads and solid fundamentals.

What is an asset allocator to do? Any words of wisdom for short-term tactical moves?

Paul Jackson (London): We are living in a world of extreme uncertainty. Assessing the financial market implications of a partial or total economic shutdown in a range of important economies is virtually impossible. Given the unprecedented circumstances, the best we can do is construct a range of scenarios (for example, our 12-month targets for the S&P 500 range from 1400 to 3000).

We have witnessed extreme market volatility in recent weeks, and I can imagine three potential circuit breakers (against the panic): a working and approved vaccine, a clear reduction in COVID-19 cases and deaths outside of China, and policy support. Given that a vaccine is unlikely to be available for 12-18 months, in my opinion, and that non-Chinese cases and deaths continue to accelerate (with the US now becoming the center of attention), it has been left to policymakers to calm the markets.

While governments unfurl ever larger fiscal packages to protect their economies, major central banks have announced massive asset purchase programs, which have the double effect of calming markets and effectively financing the surge in fiscal deficits. Our projections for the aggregate balance sheet of the major central banks (Federal Reserve, European Central Bank, Bank of England, Bank of Japan and Swiss National Bank) suggest that expansion in the period to end-2021 may be as rapid as has been seen in the last decade (in year-on-year percentage terms). It is also our observation that such growth has tended to be followed by improved performance in global assets (according to our own global multi-asset benchmark).

However, it seems that we are in unprecedented times, and it is difficult to yet quantify the economic damage wrought by attempts to control COVID-19. Our very worst-case scenario (from which the S&P 500 1400 target arises) imagines that global gross domestic product (GDP) could shrink by 3.5% this year and that markets return to Global Financial Crisis conditions (in most cases, we remain far from that).

Consequently, and as I mentioned in my brief remarks in last week's blog, diversification is more important than ever but is harder to achieve than usual, given that assets are moving together (correlations have risen). Among "defensive" assets, I believe cash and gold warrant the greatest consideration for investors. Government debt could also fulfil that defensive role now that major central banks have launched big purchase programs, but yields are historically low and government deficits could reach war-time proportions (in my opinion).

I believe a barbell approach of combining those "defensive" assets (cash and gold) with commodities and real estate (REITs) could offer potential benefits. They are the cyclical assets that I think have the most upside under our more optimistic scenarios.

Equities may also be an important part of any long-term investor's portfolio. Equity markets that I believe have the most upside potential in the shorter term include the UK and Japan. However, on a global basis, I think there may currently be more efficient ways than equities to gain exposure to an economic recovery (for example, a combination of investment grade credit, REITs and commodities may potentially provide such exposure).

One asset class I would highlight in today's environment is investment grade (IG) credit. In my view, IG would seem to offer a good combination of risk, reward, and diversification potential. I am, however, more wary of high yield credit, echoing Tim's comments above.

Finally, some assets have been more impacted than others and have priced in a greater degree of bad news. In my opinion, this list includes oil (the price of West Texas Intermediate briefly touched my long-held downside target of $20 on March 30); sterling, which fell to around 1.15 on March 19 and close to historical lows versus the US dollar; and REITs (the global yield was 5.3% and US yield was 5.6% on March 26, based on FTSE/EPRA NAREIT indices).[4] Given this view, UK oil stocks may warrant consideration, as they give access to oil assets in a depressed currency.

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Source

[1]Source: Bloomberg, L.P. The four equity volatility spikes occurred in 2010, 2014, 2015 and 2020.
[2]Source: Bloomberg, L.P.
[3]Source: Bloomberg, L.P. as of March 27, 2020
[4]Source: Bloomberg, L.P. and Refinitiv Datastream

Important information

Diversification does not guarantee a profit or eliminate the risk of loss.
The CBOE Volatility Index® (VIX®) is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices. VIX is the ticker symbol for the Chicago Board Options Exchange (CBOE) Volatility Index, which shows the market's expectation of 30-day volatility.
The S&P 500® Index is an unmanaged index considered representative of the US stock market.
In a normal yield curve, longer-term bonds have a higher yield than shorter-term bonds of the same credit quality, indicating a positive economic outlook. An inverted yield curve is one in which shorter-term bonds have a higher yield than longer-term bonds of the same credit quality, indicating a negative economic outlook.
A put option gives an investor the right to sell a security at a specified price within a certain time frame. A call option gives an investor the right to buy a security at a specified price within a certain time frame.
The Economic Policy Uncertainty Index is compiled from three underlying components that quantify newspaper coverage of policy-related economic uncertainty, reflect the number of federal tax code provisions set to expire in future years, and use disagreement among economic forecasters as a proxy for uncertainty.
The US Stock-to-Bond Ratio is the S&P 500 Index divided by the reciprocal of the 10-year Treasury bond yield.
Risk off refers to price behavior driven by changes in investor risk tolerance; investors tend toward lower-risk investments when they perceive risk as high.
Quantitative easing (QE) is a monetary policy used by central banks to stimulate the economy when standard monetary policy has become ineffective.
The bid-ask spread is the difference between an asset's ask price and its bid price.
The Bloomberg Barclays High Yield Index is designed to measure the performance of below investment grade rated bonds in the United States.
In general, stock values fluctuate, sometimes widely, in response to activities specific to the company as well as general market, economic and political conditions.
Fixed-income investments are subject to credit risk of the issuer and the effects of changing interest rates. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa. An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer's credit rating.
Fluctuations in the price of gold and precious metals may affect the profitability of companies in the gold and precious metals sector. Changes in the political or economic conditions of countries where companies in the gold and precious metals sector are located may have a direct effect on the price of gold and precious metals.
Commodities may subject an investor to greater volatility than traditional securities such as stocks and bonds and can fluctuate significantly based on weather, political, tax, and other regulatory and market developments.
Investments in real estate related instruments may be affected by economic, legal, or environmental factors that affect property values, rents or occupancies of real estate. Real estate companies, including REITs or similar structures, tend to be small and mid-cap companies and their shares may be more volatile and less liquid.
Mortgage-backed securities are subject to prepayment or call risk, which is the risk that the borrower's payments may be received earlier or later than expected due to changes in prepayment rates on underlying loans. Securities may be prepaid at a price less than the original purchase value.
Municipal securities are subject to the risk that legislative or economic conditions could affect an issuer's ability to make payments of principal and/ or interest.
The risks of investing in securities of foreign issuers can include fluctuations in foreign currencies, political and economic instability, and foreign taxation issues.
The performance of an investment concentrated in issuers of a certain region or country is expected to be closely tied to conditions within that region and to be more volatile than more geographically diversified investments.
The opinions referenced above are those of the authors as of **March 30, 2020.** These comments should not be construed as recommendations, but as an illustration of broader themes. Forward-looking statements are not guarantees of future results. They involve risks, uncertainties and assumptions; there can be no assurance that actual results will not differ materially from expectations.