Now what?

A conversation about rebalancing, risk, and unavoidable realities

Erik Ristuben, Global Chief Investment Strategist

With stock markets down roughly 30%, credit spreads widening significantly—and doing so on the back of a Treasury rally—many clients are wisely asking what actions should they be considering going forward?

To answer this, let's dig into the key issues we've been tracking that clearly impact this decision-making process:

- The path and duration of the viral outbreak itself
- The response of policymakers
- Market sentiment
- Valuations

The virus

How widespread will the outbreak become? How long will it last? And how effective will the mitigation measures be in limiting the impact? The answers to these questions are unknown at this time. But the future of the virus itself—this is far-and-away the biggest risk factor going forward for investors. We are clearly not virologists, but even the true health experts are saying they don't know the answers to these questions.

What *is* known at this time is that available evidence appears to show that the very aggressive measure taken in China and South Korea have been effective in containing the outbreak and in limiting the expansion of the virus. In fact, the hard data coming out of China indicates that economic life in that country is slowly returning to more normal levels. They are not anything near completely recovered, and things could change, but for now they seem to be moving in the right direction. Constant vigilance and monitoring will be required to maintain this recovery.

That is not to say that the steps taken in the developed world will be as effective, but as those responses begin to more closely resemble the Chinese response it would seem hope is not entirely misplaced.

Current consensus expectations—which to be clear are very volatile at this time—seem to indicate that the broad expectation is that if the major economic damage done in these attempts to control the outbreak is limited to one quarter, roughly $1 trillion of damage will be inflicted on the U.S. economy. Similar expectations are likely hold true for most other developed economies on a pro-rata basis. All this said, it cannot be understated enough, this is very, very far from certain. At a minimum, this uncertainty should inform your risk management and budgeting decision framework.

Policy response

There has been an unprecedented response by central banks to provide markets and the economy with liquidity and direct support. In fact, both the U.S. Federal Reserve and the European Central Bank are on record that there are no limits to the lengths they are willing to go to ensure liquidity.

This monetary support is necessary, but alone it is not sufficient to address this crisis. Massive fiscal support also needs to be implemented. Again, most governments in the developed world have allocated or are on the cusp of allocating significant fiscal support for the economy. If the U.S. Congress passes a $2 trillion fiscal package (which they are on the verge of doing as this is being written), it will be twice the current estimate of U.S. economic damage of $1 trillion and will represent roughly 10% of annual U.S. gross domestic product (GDP). Other countries are on this same track. The goal of all these efforts is to ensure that that the pipes and plumbing of commerce are still in place

when we are ready to return to our normal lives. In other words, both the governments and the central banks are striving to limit the number of business failures and, more importantly, to limit the destruction of jobs.

If the coronavirus outbreak can be controlled—so as to have the major negative economic impact confined to a quarter—then the size of these packages are likely to be broadly successful in achieving their objectives. This would **set the stage for a bounce back in GDP growth**, starting in the back half of 2020, as pent-up demand, massive monetary stimulus and massive fiscal stimulus converge.

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Sentiment

The animal spirits in the markets are always a factor in market performance. That is particularly true in a bear market. With the threats and uncertainties facing the economy, fear has been the most powerful mover of markets. Our sentiment indicators show that the market has moved into clearly oversold territory. But they have yet to show the typical capitulation-trade—which often signals that point in the market-cycle-of-emotions when almost all investors move into despondency.

I recall an anecdote I heard from my colleague, Andrew Pease, our global head of investment strategy. During the throes of the Global Financial Crisis, one investor was so despondent, he asked Andrew if the valuation of the S&P500 could possibly fall to zero. That level of despair has not occurred this time, even with the massive market drops we've seen. But for those investors choosing to increase portfolio risk at this time, they must keep market sentiment in mind, as it will continue to drive short-term market volatility, especially due to the unique cause and the unprecedented response.

Valuation

Broadly speaking those parts of the equity markets that were *cheaper* going into this crisis are even cheaper now and those parts that were *expensive* are much closer to fair value.

Valuation with regard to equities:

- **U.S. equities** - We considered this sector *very expensive* prior to the crisis. It is now 30% down, which is *close to fair value.*
- **Emerging market equities** - We considered this sector *somewhat inexpensive* going into the crisis. EM equities are now downright *cheap.*
- **Non-U.S. developed markets** - We considered this sector *near fair value* going into the crisis. They now look *cheap*.

In aggregate, we estimate non-U.S. stocks are currently priced at a discount of 30% relative to the U.S. markets. And the medium-to-longer-term return skew has improved considerably.

Valuation with regard to the bond market:

- **U.S. Treasuries** – We considered U.S. Treasuries *somewhat expensive* going into the crisis and now they are *even more expensive*.
- **U.S. Credit** - Going into the crisis, we considered U.S. credit as *somewhat expensive* as reflected by relatively narrow spreads. *Investment-grade bonds are now attractively priced*, although the trading in the credit market has suffered from lowered liquidity. High-yield bonds, at their worst, were effectively priced for a recession and *high-yield bonds look to be good value* at this time.

Valuation with regard to growth vs. value

Prior to the crisis, we viewed growth stocks as very expensive and value stocks as substantially cheap. The relative pricing between these two factors is now at historical highs. *Growth relative to value has never been more expensive as a factor.*

Other credit and equity instruments all conform roughly to these patterns.

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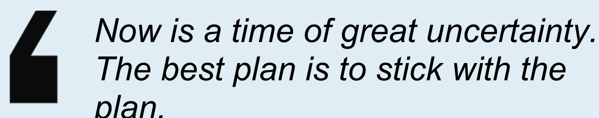
To rebalance or not to rebalance

Every one of our clients has a unique set of circumstances that needs to be assessed in terms of what they should do next. But Investors have their policies because they do not know exactly what will happen at any given moment in the markets. Now is a time of great uncertainty. The best plan is to stick with the plan.

That said, here is how our multi-asset portfolio managers are viewing all of these factors in total:

- Firstly, they have been rebalancing their portfolios throughout this drop, back toward their strategic levels.
- We are advising our clients broadly to maintain their rebalancing policies. For illustration purposes, as of March 20, 2020, a client that had a 60/40 allocation at the beginning of this downturn now likely has an allocation much closer to 50/50.
- Selling corporate bonds in this market is significantly increasing transaction costs, so a more nuanced strategy may be appropriate for more illiquid parts of the market, such as high-yield.
- As it relates to treasuries, which have actually had positive returns in this equity sell off. We see great long-term strategic value to rebalancing out of treasuries and back into risk assets at this time.
- As it relates to more of a core bond assignment, we see the strategic value of rebalancing as enough to justify the higher transaction costs.
- Market conditions change. When they do, it will require updates to this advice.

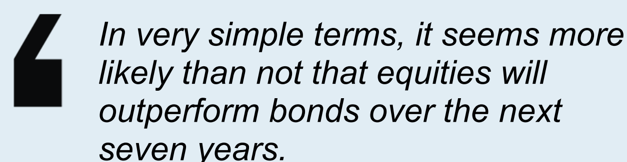


Adding risk

For those clients considering the potential of actually increasing the amount of risk in their portfolio above and beyond their policy, that is a much more complicated decision.

In our minds, the right answer depends on the investor's actual investment time horizon and their ability to suffer even more short-term pain, say, for the next 3-6 months. Not all investors are comfortable with the same levels of volatility. For more volatility-averse investors, good and correct decisions, driven by longer-term expectations, can seem wrong in volatility conditions such as the ones we are currently experiencing.

To give some context to this, clients have asked us if this drawdown could ultimately match the Global Financial Crisis drawdown of 50%. The only honest answer to this is yes. If the virus duration and impact is greater than what is currently priced-in, then yes, there is very likely a sizeable next-step-down in this bear market. Investors must be realistic about their ability to suffer that kind of shorter-term volatility and pain. Such self-awareness is critical for investors and will likely determine the success of their decisions.



With that in mind, if the investment horizon is 7-10 years or longer, it seems fairly clear that a decision to increase portfolio risk at this time—with equities 30% cheaper than they were and Treasuries even more expensive—will very probably create a meaningfully higher return in the future. In very simple terms, it seems more likely than not that equities will outperform bonds over the next seven years—and they will likely do so by more than our assumed annual equity risk premium of 4.5%. In essence, the longer-term math looks fairly straightforward, within the context of a world where nothing is certain.

While that may seem to make the decision rather simple, nothing truly valuable in life is easy. The most difficult aspect of the do-you-risk-up-or-down decision really is the ability of the investor to survive the *bad draw* of nearer-term market volatility.

As always, we at Russell Investments stand ready to help our clients walk through these issues, within the real-world constraints of their unique situations.
Contact your Russell Investment representative to start that conversation.

For more information

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