TD Wealth

Market Insights

PAIR | Portfolio Advice & Investment Research

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Certain Uncertainty:
Global financial markets react to spread of COVID-19

"Those who have knowledge don't predict. Those who predict don't have knowledge" — Lao Tzu

The volatility of financial markets in the past week is a great example of one of the hardest things to understand when investing: the difference between risk and uncertainty.

Risk

When we entered 2020, these were the certain, quantifiable risks:

1. U.S. election
2. Geopolitics
3. Trade disputes
4. Policy mistake
5. Recession
6. Credit shock

Empowered with this understanding we set allocations to mitigate losses and take advantage of the opportunities to achieve returns.

Uncertainty

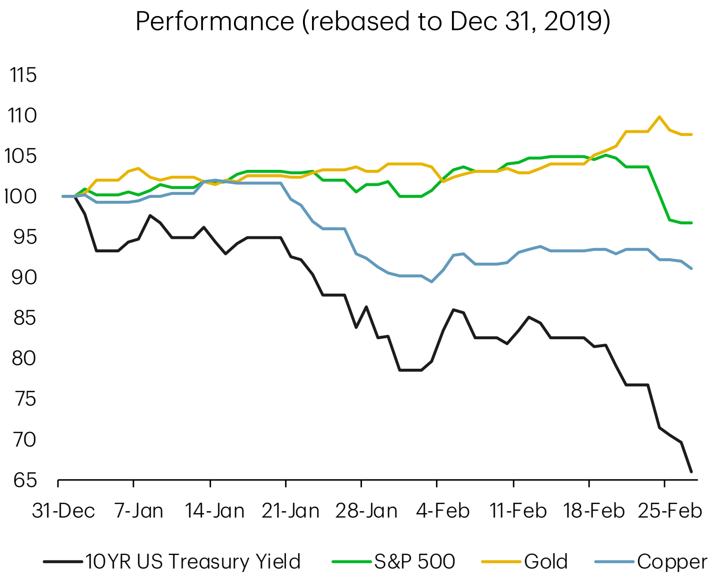
When we entered 2020, we didn't know what we didn't know. This is uncertainty, and it pertains to unpredictable events that are impossible to quantify. The coronavirus, or COVID-19, is a great example of this. In the event of such contingencies, we have built portfolios that take advantage of our "true diversification" approach, which combines asset allocation, factor diversification and behavioural finance.

For clarity: We understand that the volatility this week has been a little hard to watch. The uncertainty around the coronavirus is the one thing that unites all of us right now. We, as much as anyone, would like to know what the end game is for all of this, but the fact is, no one knows; it can't be predicted. That being said, we are not the helpless victims of market forces, and we are comforted by the fact that we have prepared for the risks and uncertainties that are currently impacting global financial markets.

What we do know

Equity markets have come under significant pressure in recent days, driving stocks lower as the number of coronavirus cases outside China continues to rise, fueling fears of a prolonged global pandemic. In reaction, investors have flooded into safe havens, driving up the price of gold, and driving down the yield of the 10-year U.S. Treasury to record lows, as well as risk assets like the S&P 500 and copper (Figure 1).

Figure 1: Safety up, risk down



Source: Bloomberg. As of Feb 27, 2020

In response to this elevated market volatility and heightened investor concern, the TD Wealth Asset Allocation Committee (WAAC) held an interim meeting to review its current asset allocation outlook, confirm suitability and determine whether strategic shifts would be required amid prevailing market conditions. WAAC determined the following:

"With a view to the next 18-24 months, we believe that our positioning between fixed income, equites and alternative/real assets remains appropriate." The same is true for current risk-factor weights (Figure 2), set by the Wealth Investment Policy Committee.

There is no question that the outbreak will have negative economic consequences. Factory work has been stalled, flights grounded, and supply chains disrupted. The virus will likely lead to downgraded economic forecasts, with some economies experiencing negative growth in the first quarter of 2020, and possibly into the second. We have no definitive way to estimate the extent of the economic damage but feel that conditions for a U.S. recession remain low given strong corporate health, low unemployment, a relatively high savings rate, and strong consumer spending. The degree of impact to economies will vary, however, as governments and central banks bring their differing response capabilities to bear.

Notably, recession fears have not worked their way meaningfully into the bond market. Reaction in credit has been limited, even as coronavirus infections spread. Investment-grade and high-yield debt are holding at low levels with spreads remaining tight, keeping corporate borrowing costs near 30-year lows.

Figure 2: Dynamic positioning by risk factor weights

We consider five macro risk factors: Equity Risk, Fixed Income Risk, Alpha, Currency Risk and Illiquidity Risk.

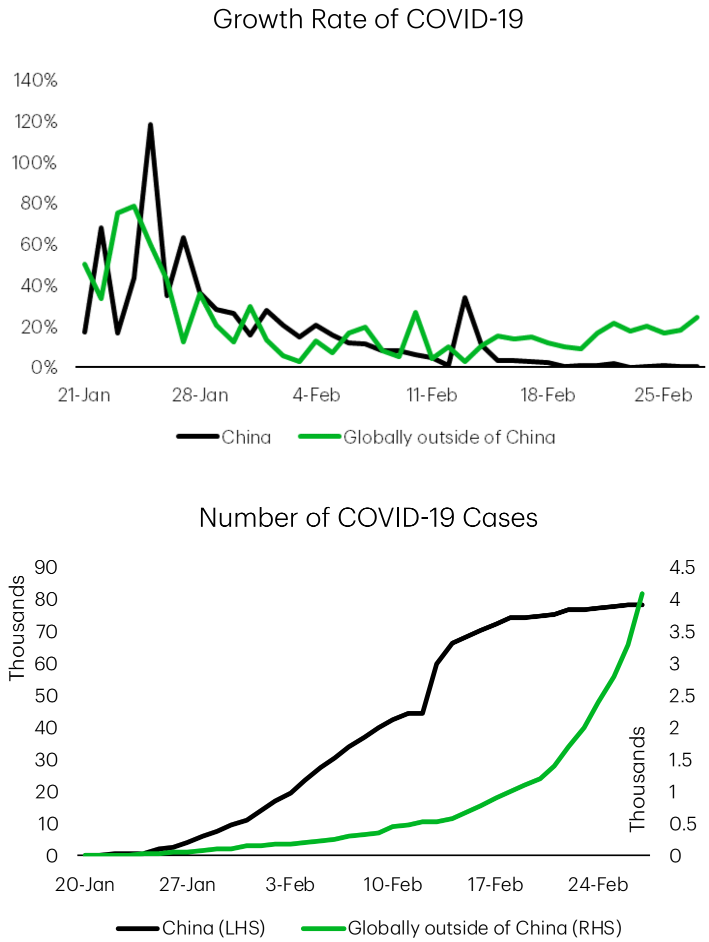
Assets	Positioning	Fixed Income Factor	Equity Risk Factor	Currency Risk Factor	Illiquidity Risk Factor	Alpha
Factor Positioning		Underweight	Overweight	Underweight	Overweight	Dynamic
Cash	Underweight	●				
Fixed Income	**Underweight**					
Domestic Gov't Bonds	Underweight	●				●
Investment Grade Corp Bonds	Neutral	●	●	●		●
Inflation Linked Bonds	Overweight	●		●		●
High Yield Bonds	Neutral	●	●	●	●	●
Global Bonds - Developed	Underweight	●		●		●
Global Bonds - Emerging	Neutral	●		●	●	●
Equity	**Overweight**					
Canadian	Neutral		●			●
U.S.	Overweight		●	●		●
International	Neutral		●	●		●
Emerging Markets	Overweight		●	●		●
Real Assets	**Overweight**					
Mortgages/Private Debt	Overweight	●		●	●	●
Real Estate/Infrastructure	Overweight	●	●	●	●	●

Source: Wealth Investment Policy Committee

There are also some positives:

1 The spread of the coronavirus in China has begun to slow, which shows that containment efforts are having a constructive impact (Figure 3).

Figure 3: Growth rate and number of cases of COVID-19



Source: 2019 Novel Coronavirus COVID-19 (2019-nCoV) Data Repository by Johns Hopkins CSSE

2 The volatility to date gives us a clearer picture of where we are and where we're going. Using the VIX as a measuring stick (also known as the "fear gauge") we went back to 1990 to take a look at what happened to the S&P 500 when volatility spiked, lifting the index above 25. Since 1990 (Figure 4), the median S&P 500 decline during periods of extreme volatility has been 8%, with a range between 3% and 23%. Upon writing, the S&P 500 is down 12%, putting it right around the average of past losses. In other words, the worst is already likely behind us.

Figure 4: Volatility indices and performance

	Starting Levels		Max (%)	
	VIX	VIX 10D Avg	SPX Loss	VIX Gain
Median	27.3	22.6	-8.1	20.3
Max	43.4	41.3	-3.3	110.8
Min	25.0	15.5	-21.4	0.0

Source: Bloomberg. As of market close Feb 27, 2020

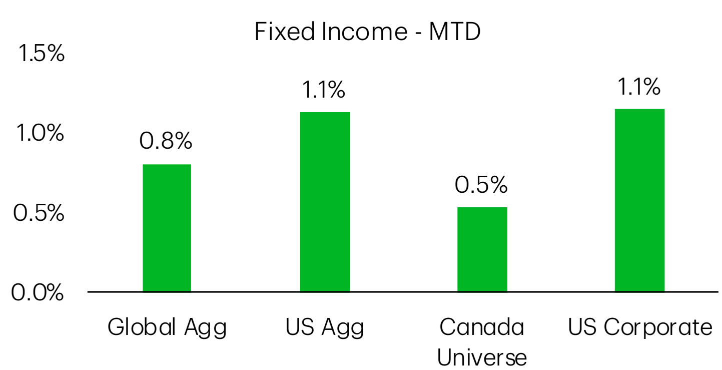
3 There is an enormous amount of central bank support in our current financial system, as we discussed in our winter quarterly strategy report, Conundrum. Global growth, while slow, is rebounding after central banks have eased more than 100 times since 2018. In fact, global central banks are cutting at their fastest rate since late 2009: the European Central Bank has, for all intents and purposes, committed to running its asset-purchase program for several more years; the Bank of Japan has provided forward guidance that is biased toward more easing; and the People's Bank of China further cut its reserve requirement ratio (RRR) by 50 basis points the first week of January. The PBOC has now cut its RRR eight times since early 2018.

While all this liquidity was being administered for market risk, it will likely have a positive impact on the current uncertainty as well.

Background

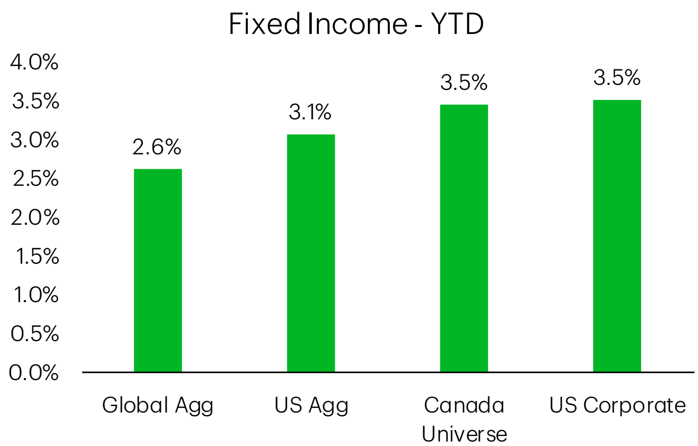
Investors had been relatively nonchalant about the COVID-19 coronavirus until recently, lifting global equities to all-time highs as of last week. However, with news that the virus had spread to Italy, Japan and South Korea, worries started to mount, provoking a classic flight to safety. Government bonds and gold rallied, while equities sold off across most markets.

Figure 5: Good and bad



Source: Bloomberg. As of Feb 27, 2020

Figure 5: Good and Bad



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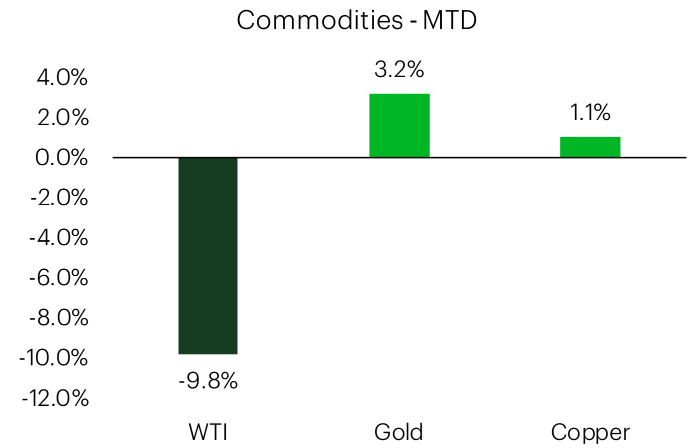

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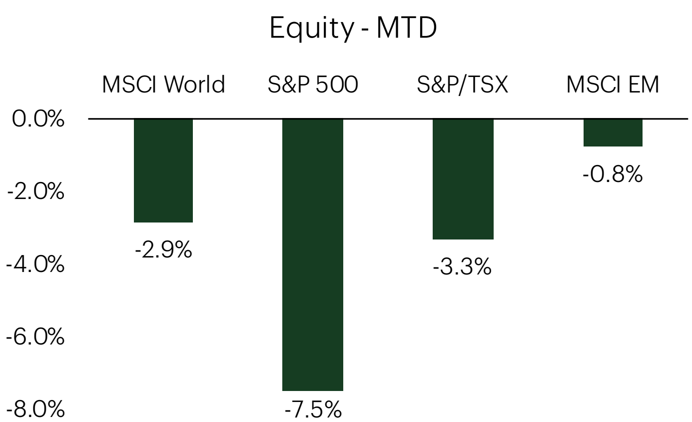

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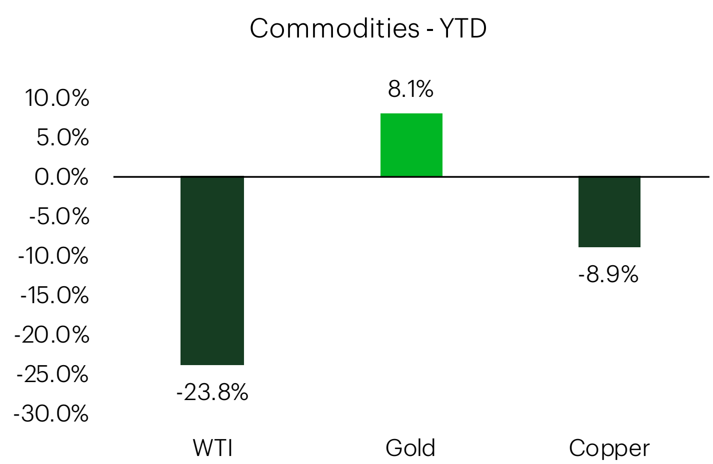

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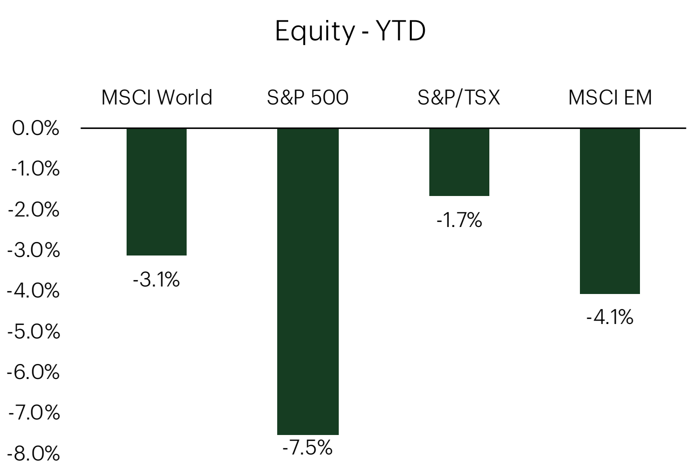

Source: Bloomberg. As of Feb 27, 2020

Potential Economic Impact

The timing of the epidemic is certainly inopportune given already heightened concerns about a global economic slowdown. Europe was already on the cusp of a recession and Japan's economic conditions have deteriorated, even before factoring in the potential impact of the coronavirus. The U.S., with strong economic trends, has been an outlier in all of this, but there are questions about how long it can last if global flow of goods and people continue to be disrupted. China, Japan, South Korea and other Asia-Pacific countries are in full or partial virus-control mode, which comes at the expense of normal economic activities. China's economy, which accounts for around 16% of global GDP, is expected to suffer a more meaningful and lingering impact, with estimates from TD

Economics suggesting annual GDP could be cut by 1% or more. While there will be some loss of activity, once evidence emerges that the virus is contained or levelling off, subsequent quarters would capture strong economic rebounds as business operations and consumer activity normalizes. If recent epidemics like SARS and MERS serve as any example, the impact of COVID-19 should dissipate within two quarters, as the virus is contained. As of February 27, the market is pricing in a 70% probability of a rate cut by the Federal Reserve in its April meeting. This probability is significantly up from 25% on February 19.

What does this mean?

Even for expert epidemiologists (and we certainly are not) it is nearly impossible to predict how far the virus will spread or how hard it will hit markets and the economy. It's too early and we simply don't know. We do know that there will be a negative impact on global economic growth, and that headlines will continue to weigh on investor sentiment. As such, risk assets will likely remain volatile while safe-haven assets will likely remain well supported. Nevertheless, we continue to advocate for a long-term view and proper diversification in order to mitigate the near-term risk. Clients should keep in mind the behavioural risks that rise in tandem with market turmoil — namely, the risk that they will compound their losses by attempting to time the market incorrectly. By maintaining a long-term view (Figure 6) and staying invested, clients will help to mitigate both external and internal risks.

Figure 6: Long-term performance

Performance	S&P 500	S&P/TSX	MSCI Emerging Market Index
3 Yr Avg Rolling Return	6.5%	5.2%	8.5%
5 Yr Avg Annualized Rolling Return	6.1%	4.8%	7.2%
10 Yr Avg Annualized Rolling Return	5.7%	4.0%	6.1%

Source: Bloomberg. As of Feb 27, 2020

The Importance of Investment Discipline and True Diversification

Maintaining investment discipline with true diversification is especially important in an environment where uncertainty is elevated. In these situations, the prudent strategy is to ensure that one's portfolio is resilient and well-diversified, not just across asset classes and geographies but also across risk factors and macroeconomic environments. This way, the portfolio is not overexposed to any adverse event that could potentially have an outsized negative effect on its value. Some asset classes can be expected to underperform as risk appetite wanes (notably risk assets such as equities, high-yield bonds and emerging-market, local-currency debt) and some will perform better (notably rate-sensitive assets like high-quality bonds and real estate and infrastructure) but the key is to construct and maintain a balanced portfolio that is truly diversified.