Confidence must be earned

Amundi ASSET MANAGEMENT

February 28, 2020

COVID-19: Response and Containment

INVESTMENT TALKS

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Overview

Our expectation is that the coronavirus will have significant, but not structural, impact on the global economy. Currently, the primary source of economic damage is from the dramatic and seemingly non-unified global response to the health emergency.

Initially, financial markets were most concerned with China and its response to contain the virus. Draconian quarantine measures appear to be making headway in containing the virus. However, market attention has shifted from China to the rest of the world.

Pandemic risk is now spreading across the globe. The economic damage caused by policy responses has been underestimated, and will continue to feed financial market volatility. Only when the increase of infection subsides will manufacturing activity and consumption resume and fulfill our expectations of a healthy recovery. We would expect global policy makers to stimulate the economy using fiscal and/or monetary policy, if necessary.

We expect that US and global growth will suffer a setback that may bleed into the second quarter of 2020, before mostly regaining pre-crisis expansion. We have downgraded our economic growth forecasts in consideration of the COVID-19 crisis. The likely economic damage to China will be considerable. The critical unknown remains global containment of the virus, which will determine the extent and breadth of the recovery.

While we do not believe that US fundamentals support Fed action, there is increasing pressure on the Fed to do so in response to tighter financial conditions and an inverted yield curve. While lower short-term interest rates may not spur spending during a health epidemic, the markets are increasingly demanding reassurance from the Fed's use of its contemplated "financial instability escape clauses". A decisive 50 basis point "emergency cut" is not out of the question. As of the February 27, the futures market predicted that the Fed Funds Rate will be at least 50 basis points (0.5%) lower by the June meeting of the Federal Open Market Committee (FOMC). and potentially 100 basis points (1.0%) lower within the year. This would be up from a pre-crisis estimate of one 25 basis point (0.25%) cut in December, and again during 2021.

US Equity Markets

Equity markets have reacted violently to the growing uncertainty over the spread of the coronavirus and the impact of policy responses on the global economy. Heightened concerns secondarily exist around the novel coronavirus itself, and its transmission, adaptability and contagiousness.

US stocks are on track for their sharpest selloff since the 2008 financial crisis. We believe active management, focused on generating attractive returns while mitigating downside risk and volatility, can help buffer investor portfolios. At this point, given the US equity market's slowdown, cyclical value has less appeal.

US Fixed Income

With global markets in turmoil, 10- and 30-year Treasury yields are at all-time lows, driven by investors seeking an “insurance policy”. US 10-year Treasuries are down over 70 basis points (0.7%) since the beginning of the year, and more than 30 basis points (0.30) since the end of last week. High yield bonds are trading thinly and price discovery is clouding the measurement of this spread widening. Investment grade credit is showing signs of stress. In this environment, new corporate bond issuance has seized; the secondary market remains under pressure. Agency mortgages and securitized credit are functioning and holding in relatively better, reflective of sound domestic fundamentals.

The “risk free rates” of Treasuries, which are backed by the full faith and credit of US government, seem overvalued, and there are attractive opportunities to invest in selected credits where bearish sentiment is incongruent with fundamentals, even under stressed scenarios.

Conclusion

For the US financial markets, our base case belief is that calm will return, but not before presenting excellent opportunities to capitalize on investment in sectors and securities trading under the cloud of indiscriminate risk aversion. The key remains global response and containment.

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Definitions:

- **Basis Point –** A unit of measure used to describe the percentage change in the value or rate of a financial instrument. One basis point is equivalent to 0.01% (1/100th of a percent) or 0.0001 in decimal form. In most cases, it refers to changes in interest rates and bond yields
- **Spread –** The difference between two prices or interest rates.
- **Spread Widening:** US treasury prices to rise and yields to fall while corporate bond prices fall and yields rise
- **Duration:** A measure of the sensitivity of the price (the value of principal) of a fixed income investment to a change in interest rates, expressed as a number of years.
- **Risk free rate of return**: The risk-free rate of return is the theoretical rate of return of an investment with zero risk. The risk-free rate represents the interest an investor would expect from an absolutely risk-free investment over a specified period of time. The real risk-free rate can be calculated by subtracting the current inflation rate from the yield of the Treasury bond matching your investment duration.

Date of First Use: February 28, 2020