Policy to the rescue? How much longer will the financial turmoil continue?

The daily whipsaw of financial market volatility continues as investors struggle to determine just how bad the economy will get and how long it will take to emerge from the still-growing coronavirus pandemic. As Nuveen’s Global Investment Committee points out, it’s too early to look for a bottom, but we are seeing signs that financial conditions are starting to stabilize.

*Insights from*
*Nuveen’s Global Investment Committee*

**HOW ARE MARKETS LIKELY TO REACT TO EXPANDED ACTIONS TAKEN BY THE FEDERAL RESERVE AND OTHER POLICYMAKERS? WHEN CAN WE EXPECT MARKETS TO RECOVER?**

We are at the start of a deep global recession whose length will depend on the world’s ability to contain the spread of the virus and how deeply the countermeasures taken will hurt growth. Markets are already anticipating this sharp downturn and are stressed by liquidity shortages, with risk assets sustaining mark-to-market losses consistent with a recession. The dual response globally from central banks and fiscal stimulus is intended to cushion the market drop and fuel the eventual recovery by keeping markets running smoothly while we wait for this to happen. In the U.S., comprehensive Fed actions such as purchasing corporate bonds are going beyond measures taken by the central bank during the global financial crisis. While fiscal policy continues to evolve, the key question remains: Will stimulus measures clear the path for a “return to normal?”

At this point, it is too soon to talk about the start of a recovery. Lagging indicators such as developed market economic data and corporate earnings haven’t been reported yet, and we believe we are still on the way into the recession, not on the way out. In further proof that the coronavirus is taking an economic toll, Markit’s purchasing manager’s index (PMI) released today reflected the steepest downturn since March 2009. Nonetheless, there have been some positive signs: Markets have been functioning better, volatility has decreased so far this week, and after spiking last week, the U.S. dollar has been weakening. All these signs offer hope that the worst of the panic selling could be in the rearview mirror. And while it is still early, China is starting to see some better conditions, and when
the recovery does happen, China will likely lead on the upside.

While we don’t think we are near a recovery yet, some conditions that would signal the start of that process include a decline in the number of new virus cases, recovery in Chinese PMI numbers, normalizing liquidity in bond markets, declining volatility and stabilization in the number of initial jobless claims.

**HOW COULD FACTORS SUCH AS POTENTIAL BANKRUPTCIES AND LOWER TAX REVENUES AFFECT WORLD ECONOMIES AND GDP?**

Both of these factors are likely to contribute to what could be a deep recession. If the economic impact from coronavirus and the related countermeasures last for several quarters, corporate defaults for below-investment-grade companies could rise to over 10%. The energy, retail, travel and leisure and airlines sectors would be especially vulnerable to rising defaults. In the housing sector, however, we expect much lower borrower delinquencies compared to 2008, given lower leverage and tighter borrowing standards. Without knowing the length of this crisis, it’s hard to gauge. But the good news is mortgage servicers have put in forbearance plans and halted foreclosures and evictions to reduce forced selling into this market – similar to during natural disasters. We won’t know the initial impact of coronavirus on consumer credit until mid-April, when we could see an uptick in delinquencies.

Going into the coronavirus shock, tax receipts from individuals in the U.S. were at normal levels through February, and rolling 12-month receipts were up a healthy amount from the prior year. However, tax revenues have historically tracked closely to GDP growth, so as expectations for economic growth turn more recessionary, we anticipate overall tax revenues from individuals and corporations to decline across the state and federal levels. The federal deficit will likely expand from fiscal stimulus, while corporate tax receipts will fall significantly as earnings decrease. On a sector level, industries, such as energy, will be hit hard.

**HOW HAVE REAL ESTATE INVESTMENTS BEEN AFFECTED? WHAT IS THE OUTLOOK FOR THE ASSET CLASS AND WHERE ARE THE OPPORTUNITIES?**

Real estate is, for the most part, an illiquid asset class and not susceptible to pricing swings stemming from reactive selling. Sure enough, real estate has experienced muted volatility compared to public markets. In our view, it is too early to speculate on pricing impacts across most sectors, since real estate is generally a long-term investment. Investors are currently employing varying strategies, with some applying a wait-and-see approach on current transactions, while others are aggressively purchasing in high-demand sectors like housing and industrial properties.

Real estate holdings that serve as a gathering places and depend on a sales-driven model, such as lodging, gaming, leisure and retail, are experiencing large declines in production and are unlikely to recover quickly. Many malls have closed, and those that remain open have experienced 50% declines in foot traffic week over week. On the bright side, we are starting to see some slow recovery in real estate in China. Many retail outlets have re-opened for business, albeit with some operating restrictions. Ports are open, and activity is returning to normal. In the U.S., transportation and logistics are showing resilience.

Looking ahead, real estate tends to perform relatively well during recessions, as it benefits from long-term leases and illiquidity. Over the next several quarters, as labor markets wane and corporate earnings shift, we expect properties around the world with underlying strong credit tenancy and durable rent collections will be more resilient. Government subsidies should help real estate as consumers and tenants benefit and increase demand.
WHAT IS THE OUTLOOK FOR EQUITY AND FIXED INCOME MARKETS? WHERE ARE THE OPPORTUNITIES?

Although monetary and fiscal policy actions are being deployed to limit further damage to the economy and to markets, they alone cannot spark a recovery. In order for a real recovery to occur, we need improvement to the core of the health crisis – specifically, containment (in the absence of a breakthrough vaccine or treatment). So, while policy will undoubtedly have a positive effect, we continue to caution against calling a bottom in equities and other risk assets such as high yield at this point and urge patience. We do believe that the bulk of the selling may be behind us as the number of new 52-week lows at the New York Stock Exchange is falling and technical conditions are improving.

Within equities, we favor companies with strong balance sheets and low debt levels, including in sectors such as health care suppliers. Defensive areas such as consumer staples and household goods also look attractive, but as we come out of this, these sorts of companies may lag after running up during the crisis. Overall, technology and health care look attractive from a long-term perspective, as do digital companies and those that have a significant online presence.

As markets start to recover, we expect consumer sectors to rebound as the country reopens for business and the healthy U.S. consumer reengages. Cyclical stocks are also showing some stability and better performance on rallies. We also see select opportunities in deeper value and small cap areas and in select financial sectors (e.g., banks are in much better shape than they were in 2008), but near-term risks remain. On the other side of the crisis we think travel booking companies look attractive as consumers start to spend again.

In fixed income, we have seen a significant repricing across all sectors of the market, with lower quality and less liquid sectors suffering the most damage. While there is still a long way to go before we see normal liquidity conditions, the Fed’s liquidity measures are helping.

We prefer quality and resilient companies in the corporate bond market. We are also seeing select opportunities in both high yield and bank loans and favor the higher quality areas of those markets. Additionally, we see solid opportunities across securitized assets. Despite a liquidity crunch, we still believe municipal bond fundamentals appear strong and valuations look attractive.

HOW SHOULD INVESTORS APPROACH PORTFOLIO CONSTRUCTION AND REBALANCING?

Our base case remains a steep dip in global growth in the first half of the year followed by a recovery starting in the third quarter, but we continue to stress that now is not a time to panic or abandon long-term investment plans. Rebalancing has been a big point of discussion among our clients, and we continue to advocate that investors rebalance as part of their routine portfolio maintenance but make any changes gradually. That could mean selling safe havens that have expanded to command a larger portion of a portfolio to buy riskier assets like equities that may now be attractively priced.
For more information, please visit us at nuveen.com.

Endnotes

Sources

Bloomberg, Markit

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A word on risk

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