

Investing amid uncertainty: coronavirus, volatility and portfolio construction

As the coronavirus continues to spread around the world, so too does economic uncertainty and global financial market volatility. Yet investors' long-term goals and plans have not shifted. So how should investors approach the markets during these times of uncertainty? Nuveen's Global Investment Committee offers perspective on what's happening, what to expect and what to do.

*Insights from
Nuveen's Global Investment Committee*

How much worse could all of this get?

Unfortunately, no one knows. But from an investments perspective, we can make some educated guesses. One reason for the high level of uncertainty is financial markets respond to real and perceived risks much faster than a virus can spread or actual economic data are released. Three weeks ago U.S. stocks were at an all-time high. Today, we are approaching a bear market, Treasury yields have plummeted to record lows, and oil prices have collapsed. That has happened much faster than we have seen reliable numbers of new coronavirus cases or economic data releases from February and March.

Nevertheless, there have already been some negative economic effects. Demand in China has fallen, negatively affecting global exporters and commodity prices. Global supply chains are being disrupted, and we are seeing diminished travel and leisure

spending. We're also seeing an OPEC-sanctioned commodity price plunge, which risks causing an energy recession, creating significant downside in energy stocks and credit sectors similar to, or potentially worse, than what happened in 2015-2016. Looking ahead, we could see a broad slowdown in consumer spending, especially if we experience widespread quarantines. Affected businesses could also start to lay off workers.

Given that backdrop, we expect little if any global economic growth in the second quarter. While Chinese growth may begin to recover from its Q1 swoon, the U.S. and Europe will surely take a hit. A potential silver lining: while these types of shock can arrive quickly they can also leave quickly as businesses and consumers revert to prior behavior, restocking inventories and making up for lost consumption. Our base-case scenario is that we are in the midst of what will most likely turn out to be a "V-shaped" bottoming in economic growth and risk asset prices. The question we cannot yet answer: How deep will the dip in the "V" be?

How will we know when we have hit a bottom?

At this point, investors seem desperate for something positive that could alleviate fear. Last week's Fed rate cut didn't turn out to be that catalyst, which shouldn't be surprising given that monetary policy can't affect the speed of the virus spreading or support energy prices. While investors are still expecting more rate cuts, they are also looking for additional policy responses such as payroll tax cuts, small-business credits or delayed tax collections in the travel sector. Outside of financial policy, people around the world are desperate for clarity on questions such as how, when and where to access virus testing, how many testing kits will be made available and what sort of additional countermeasures will be taken. Our investment teams would need to see five developments before we'd be comfortable calling a bottom:

- 1) A plateauing of global coronavirus cases along with a peak in daily new cases;
- 2) Stronger public health and economic policy responses from governments and policymakers around the world;
- 3) Capitulation on 2020 corporate earnings expectations that would cause a more realistic valuation for the equity market;
- 4) Confirmation of economic stabilization in China;
- 5) A move away from extreme pessimism in fixed income

How to approach portfolio construction and asset allocation?

Our best answer is that we don't think investors should change their long-term investment approaches. No one can yet anticipate the full impact of the virus, and it's equally difficult to predict near-term market movements. This same uncertainty makes it impossible to time the market bottom or recovery — which is exactly why we think investors should NOT try to exit and reenter into stocks or other risk assets to avoid the turmoil. Instead, we think investors should stay focused on their long-

term goals: Stick with rebalancing plans, review asset allocation strategies and confirm that investments match liability or spending needs.

At the same time, we are also talking with our clients about options to take advantage of volatility to rebalance their portfolios into quality areas of equity such as well-positioned growth and economically defensive stocks that are less levered to the economy, high quality companies focused on responsible investing practices and even hard-hit sectors like U.S. small-caps and value styles. In our view, the case for “stocks over bonds and cash” looks about as attractive as it has since 2012, but there is an open question as to where corporate earnings are heading and how much longer the near-term volatility will persist.

Our main point about asset allocation: Diversification becomes even more critical in this environment. This means not only diversification between and within different asset classes, but also diversification of time horizons by looking more closely at private and illiquid investments.

What is the outlook for equity markets? And where are the best opportunities?

We can't tell at this point how much further the selloff could extend. And it's important to remember that before the coronavirus crisis hit, markets had been overbought and fully priced. At this point, the main variable is probably the outlook for corporate earnings. At the start of the year, we were concerned that 2020 earnings expectations were too high. They have since come down modestly, but it's going to be hard to create accurate estimates until we see more economic data. Some analysts are currently predicting flat earnings growth for 2020, and if that is correct, stocks now seem to be more or less fairly valued.

As we previously indicated, the real question is how are stocks valued compared to other asset classes? As of the time of this writing, about 90% of S&P 500 companies have a dividend yield higher than

that of the 10-year U.S. Treasury, which is unprecedented. This suggests that stocks look attractive compared to bonds, but downside risks remain high. It is important to remember that market bottoms are rarely events, but are processes that can take some time. We have undoubtedly seen some damage to economic and corporate fundamentals and don't expect stocks retrace to new highs any time soon.

In terms of portfolio positioning, over the longer term, we prefer quality growth stocks, favoring companies that exhibit stable growth, strong balance sheets and that trade at reasonable prices—both within the U.S. and global markets. On the other side of the current market dislocation, we also think affordably priced cyclical stocks could snap back once the underlying health of the economy resumes. Finally, we think investors looking to reduce risk amid ongoing market volatility should look at high quality yield-oriented stocks.

consumer sector, for example, still enjoys strong fundamentals, as does the financial sector. Select investment grade bonds in these areas could be poised for better performance when we see more economic clarity. Likewise, we think structured securities, mortgages and some emerging markets debt areas (especially those not focused on energy production) look attractive. We'd also suggest that less liquid areas of the market like private credit investments could be a good option for those investors with longer-term time horizons.

How should investors be positioned in fixed income markets?

Similar to our views on equity markets, it's too soon to call for rising interest rates or narrower credit spreads. We expect the Federal Reserve to remain aggressive in promoting growth. We could envision the yield on the 2-year Treasury approaching zero and perhaps dipping into negative territory. The 10-year also still has room to fall in the near term, but we don't currently see that benchmark rate dropping to or below zero. Credit spreads have widened back to around the levels we saw at the end of 2018. If conditions worsen, we could still see further widening (e.g., if oil prices continue to plummet, it's easy to envision high yield energy spreads widen to the levels they hit during 2015-2016).

For fixed income positioning, we have been advocating for a broadly defensive stance for some time, which hasn't changed. However, that doesn't mean we advocate moving out of credit investments. Rather, we think investors should focus on relatively higher quality within the bond market. The

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Endnotes

Sources

Bloomberg.

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