

Frequently Asked Questions: COVID-19 and Oil-Price Shock

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Equity markets have been falling amid growing uncertainties about the novel coronavirus (COVID-19) outbreak (which the World Health Organization just declared a pandemic) and concerns about the surprise oil-price war between Russia and Saudi Arabia. Given the significant impact these events have had on the market environment, our investment team has provided answers to the following frequently asked questions:

Q. Saudi Arabia's move to slash oil prices has made headlines. Will this push the US economy into recession?

A. We do not expect lower oil prices to cause a recession. Historically, when oil prices double, the US economy moves toward recession. When oil prices fall, stock prices take a hit—but consumers and businesses spend less money on oil and gas, which results in increased disposable income. This silver lining is balanced against the prospects of debt defaults by higher-cost US oil producers, which could lead to potential job losses in the shale oil fields. Overall, the impact of lower oil prices on the US economy is a bit of a mixed bag given how important domestic oil production has become in the last decade. Shale producers have faced a difficult environment for several years now. This will make that worse, but the broader savings to businesses and households could offset the damage. It's probably a net-positive at the margin.

Q. Will the virus push the global economy into recession?

A. We expect to see a handful of technical recessions around the world (defined as two quarters in a row of economic contraction, measured by gross domestic product) as global economic growth continues to slow. However, it ultimately depends on how long the pandemic lasts—and how well the healthcare system of each impacted country copes with the spread.

The virus itself is an unusual catalyst for recession. Its rapid spread will certainly have an impact on the global economy. We anticipate weak economic data going into the second quarter that will likely extend into the following three-month period. But markets should begin to improve if and when the impacts of the virus and related containment measures start to fade.

Q. Is SEI making significant changes to its strategic allocation in response to COVID-19 or the oil-price shock?

A. We are not making significant changes to our portfolio allocations.

Q. Are the managers that work with SEI trading on COVID-19 news?

A. Trading by our sub-advisors has been modest. The recent volatility has only served to accelerate already-initiated changes. For example, exposure to China was being reduced prior to the COVID-19 outbreak due to the country's already-slowing economic growth. Other changes have been taking place at the margins, mostly trimming exposures in affected sectors (travel, luxury goods).

Some funds were already positioned defensively (for example, those primarily allocated to investment-grade fixed-income securities).

Q. What changes should investors make to their portfolios in response to the market downturn?

- A. Our overarching belief is that it's generally best to stay the course. Events like this are built into long-term expectations. In our view, it is unwise to modify strategic portfolios unless the adjustment is in response to a change in personal financial goals or risk tolerances. We believe that abandoning an appropriate and diversified investment strategy is too risky and costly.

Still, large moves in the market do affect investor behaviour. The urge to take action in the face of losses can be strong. We think that investors who want to “do something” are best served by reviewing their goals and risk tolerances. If those have not changed, market volatility is not a good reason to make portfolio changes.

Q. What is your view on equity market volatility?

- A. We expect to see sharp volatility in both directions in the weeks ahead, given the surprise oil-price conflict and uncertainties about COVID-19 as companies try to determine its impact.

Our understanding is that COVID-19 will get worse before it gets better, and this is reflected in recent volatility: Financial markets have reacted to headlines about the virus with daily swings of 2.5% or more.

Q. What is your view on rate cuts by central banks?

- A. We were surprised that the US Federal Reserve (Fed) made an emergency 50-basis-point cut just two weeks ahead of the upcoming March meeting (particularly since US equities recently had a significant jump). The market appears to be pricing in an additional rate cut after the next Fed meeting on 18 March.

The Fed is able to allocate additional funding to help markets if the virus get worse, but it can't do anything targeted. The bottom line on interest rates will be 0%; after that, the Fed will have nothing but unconventional methods to use.

Elsewhere, the Bank of Canada made a 50 basis-point cut after its 2 March meeting, as did the Bank of England on 11 March. Australia and European Central Bank also cut rates. The reductions should provide long-term support in the face of weak inflation (which we expect).

Q. What do you expect to see in terms of long-term damage to the global economy?

- A. We expect the coronavirus to have a real impact on the global economy. Companies are beginning to shut down travel and cancel conferences. This is already translating to fewer plane rides and less dining out in restaurants. Sporting events are being played in empty stadiums. Since the US came into this crisis with a higher economic growth rate, it may only have slowing growth—or perhaps just one quarter of decline. Unlike the housing bust, which had years of downturn before it dipped into a recession, we could see a quick turn to the upside as COVID-19 fades.

Q. What is your perspective on the macroeconomic environment?

- A. Before the onset of COVID-19, things were looking up. Continued growth in the US, stabilising growth in China, a trade agreement between the US, China and Mexico, and an improving situation in Europe were all positives for financial markets. We view the virus as a major short-term disruption. We also expect the oil shock to be a short-to-medium-term event.

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