Market Risk Insights

Portfolio triage: navigating the coronavirus sell-off

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Q2 2020

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"If we can winter this one out, we can summer anywhere"

Seamus Heaney, Irish poet, 1972

The first quarter of this year was not quite earth shattering, but the coronavirus pandemic has certainly had a significant impact on public spaces, financial markets and the daily lives of individuals. Large swathes of the global community remain in lockdown as the world wrestles with a global health crisis that is swiftly evolving into an economic shock of historic proportions.

The collateral damage caused by the crisis to businesses, financial institutions, livelihoods and government services is immeasurable, while a collapse in both demand and supply has resulted in extreme volatility and a plummeting oil price.

The visceral nature of this crisis has sharpened the focus on risk in both our personal and professional lives. We face risks to our own health and that of our loved ones, while the compression of hospital admissions has created existential threats to our health providers.

The shutdown of shops and services has imperilled their survival, acting as a sharp reminder that cash is king – and that without cashflow, paying rent, interest and suppliers is an increasingly tall order.

The concept of triage is used by medical professionals to assign degrees of urgency to illnesses in order to decide the order in which patients are treated. It has been acutely in focus in recent weeks, as hospitals have been faced with the prospect of prioritising access to vital equipment such as ventilators. There are five categories of triage:

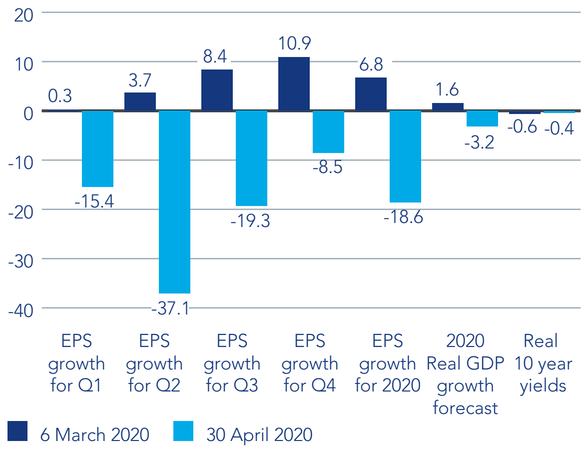
1. Immediate: life-saving treatment is required immediately
2. Urgent: casualties require significant intervention as soon as possible
3. Delayed: patients require non-urgent medical intervention
4. Expectant: the injuries are so severe that attempting to save them would divert resources from other patients who have a better chance of survival. There is no meaningful chance of a successful outcome.
5. The patient is already dead.

In this edition of *Market Risk Insights*, we attempt to triage our usual categories of risk. Each one has been amplified by the current crisis. But, as we can see in the case of environmental, social and governance (ESG) risk, with crisis sometimes comes opportunity.

Coronavirus crisis: warnings signs flash red

In the last issue of *Market Risk Insights*, we discussed how US growth had slowed in the years since the financial crisis. This lacklustre trajectory has been upended by the coronavirus pandemic. Consensus estimates suggest that growth will contract in both Q1 and Q2, before recovering slightly in the second half of the year. Estimates of earnings growth have also been reduced (see figure 1).

Figure 1: Modified forecasts for US GDP, yields and earnings per share (EPS) in 2020



Source: Factset, Bloomberg, as at April 2020. The chart compares 6 March (the last working day before Black Monday, when markets declined in response to fear about the coronavirus pandemic) and the end of April.

Some commentators are more optimistic and think that the fall-off in growth will be a technical recession, arguing that that the economy is poised to rebound strongly in the second half of the year. But considerable uncertainty remains. Programs for reopening – where they exist – are dependent on the number of cases, which can be difficult to ascertain without adequate testing programs.

The shutdown of shops and services has imperilled their survival, acting as a sharp reminder that cash is king

The response from central banks has been swift and expansive, with a global pattern of interest rate cuts. The Federal Reserve (Fed) and European Central Bank (ECB) have led the charge with a "no limits" commitment to shoring up markets through bond purchases.[1]

Following a series of small "insurance cuts"[2] at the end of 2019, the Fed has since slashed interest rates to close to zero. The Fed's commitments are the most far-reaching: its Secondary Market Corporate Credit Facility – one of seven support programmes – includes fallen angels[3] and high-yield exchange-traded funds (ETFs).

[1] 'ECB's commitment to the euro has "no limits": Lagarde', published by Reuters on 19 March 2020.
[2] 'Powell testimony, Fed meeting highlight case for "insurance"', published by Reuters on 10 July 2019.
[3] Issuers downgraded from investment-grade status.

In addition, the Fed has turned to fiscal measures like small-business loans and payroll-protection programs. It has also expanded unemployment benefits, using them as a form of bridge financing to stem the losses from frozen operations.

Global market performance year-to-date has been sharply negative. A steep, sharp fall was followed by a swift (but only partial retracement) that was seen most clearly in the US. While volatility has spiked and subsequently retreated, liquidity across equity markets remains robust.

Meanwhile, fixed-income liquidity has contracted sharply on both the buy and sell sides (read more about this in our recent piece). A large number of companies have either been downgraded or are due to be, which has swollen the ranks of high-yield bonds. Higher-quality credit tends to be the most liquid – making it easier to sell – and has moved most.

With cash flow in peril, companies have drawn on their revolving credit facilities. Defaults are rising, although financial institutions have been encouraged to show forbearance on loan covenants and to extend new lending.

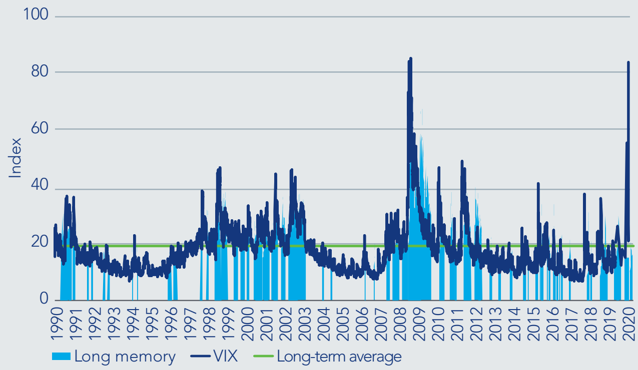
There has been modest but notable divergence between sectors. Defensive sectors that have held up best include 'stay at home' stocks and pharmaceutical companies working on anti-viral medicines and vaccines.

Meanwhile, energy-related stocks have moved sharply. Commodities have not acted as a hedge during the recent market turmoil and the price of oil has fallen dramatically in response to concerns about supply and demand. Given that most transport infrastructure is curtailed, demand is now the most pertinent issue.

In previous editions, we have looked to the yield curve as a harbinger of a recession (although noting that an inversion can sometimes be a false positive). Given the current market shock had an exogenous trigger, any link between the yield curve and a recession is more likely to be a coincidence. The yield curve is not currently inverted, although it will be interesting to see what effect the current crisis has on its shape.

In the meantime, we consider the impact that the extraordinary first quarter of this year has had on our usual indicators. As usual, we start with the complacency indicator.

Figure 2: Complacency indicator



Source: Federated Hermes, Bloomberg, The Chicago Board Options Exchange, as at April 2020.

What does it measure?

How sensitive equity investors are to general market conditions.

What does it consist of?

The US equities volatility index, or the 'VIX'. We compare volatility high points to the sum of daily volatility readings from the start of a jump to its conclusion.

How to read it

The complacency indicator is low when markets are fragile and higher when they are relaxed. The longer calm prevails, investors become more complacent and susceptible to another spike. The previous largest spike on the graph reflects the period surrounding the financial crisis, when the VIX surged, volatility jumped and investors were affected for a year and more. This has now been matched by the surge in volatility during the initial spread of the coronavirus.

What does the latest reading show?

Volatility spiked to its highest level since the financial crisis in March, as markets reacted swiftly to the global spread of the coronavirus. Markets fell by 34% over 23 trading days, which was the fastest decline on record. While volatility has eased, it is likely to persist at elevated levels.

In this issue, we consider six key aspects of market risk.

1. **Volatility**
2. **Correlation**
3. **Stretch**
4. **Liquidity**
5. **Event**
6. **ESG**

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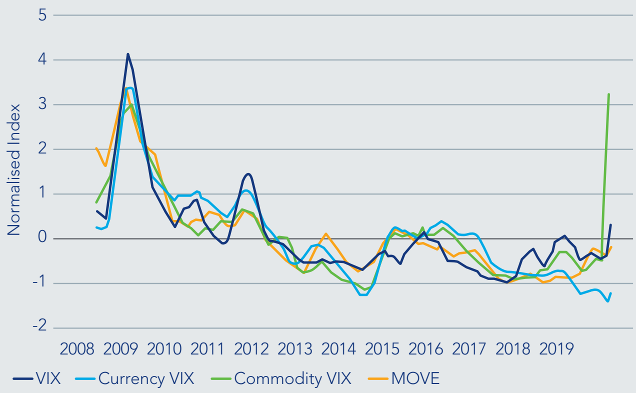
Volatility
Investor fear spikes

This year started much as 2019 finished, with relatively low volatility across asset classes. Yet as the coronavirus pandemic spread west from Asia, volatility surged. At the height of the current crisis, the VIX – an expression of investor fear – surpassed the lofty levels last seen during the financial crisis.

This crisis is driven by a new virus, which currently has no cure or vaccine. Volatility is likely to remain stretched until the end of the public-health crisis is in sight and economies start to reopen, assess the damage and implement repairs.

We examine volatility through a variety of lenses, beginning with the most common method: standard deviation from historical norms.

Figure 3: Standardised, long-term moving average volatility



Source: Federated Hermes, Bloomberg, Chicago Board Options Exchange, Deutsche Bank, Bank of America Merrill Lynch, as at April 2020.

What does it measure?

The implied volatility of equities, government bonds, currencies and commodities.

What does it consist of?

The 52-week moving average of the VIX, Merrill Lynch Option Volatility Expectations Index, Deutsche Bank FX Volatility Index and the expected volatility of the Bloomberg Commodity Index.

How to read it

The graph standardises each metric of volatility to make them directly comparable. Each index represents the market's expectation of future volatility and is often viewed as a benchmark of risk appetite.

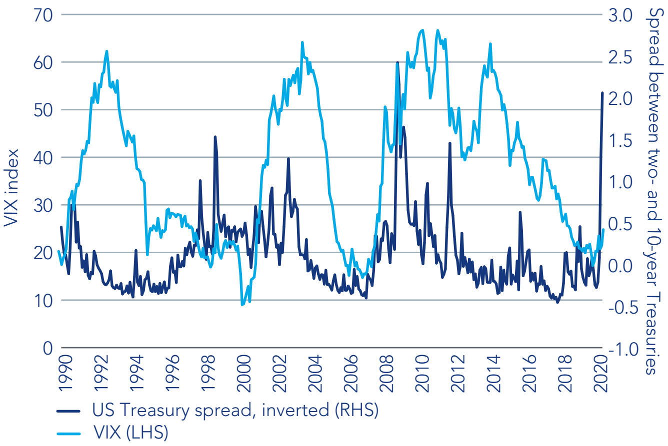
What does the latest reading show?

Every volatility indicator has spiked over the past few weeks, although the commodity VIX recorded the most pronounced move in response to the oil-price collapse. Equity volatility also rose significantly as markets reacted to the first indication that the coronavirus outbreak had become a global pandemic.

The substantial rise in volatility was matched by a significant sell-off in risky assets, including equities and commodities. The surge in equity volatility – and spike in credit spreads – prompted investors to run to government bonds for safety. US 10-year government-bond yields dropped from just over 1.5% before crisis to a low of 0.54%.

To gain another angle on volatility, we also examine the well-established relationship between Treasury spreads and the VIX.

Figure 4: Treasuries as a predictor of equity volatility

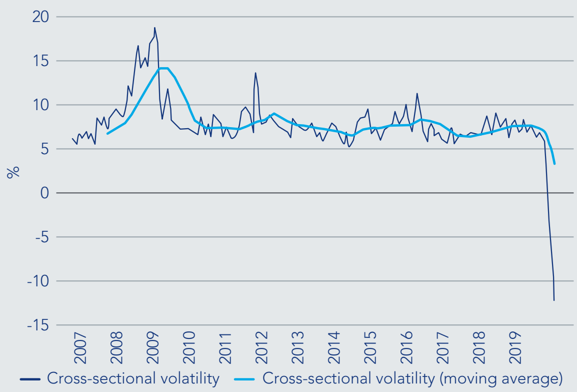


Source: Federal Reserve Bank of St Louis, as at April 2020.

The spread between US two- and 10-year yields increased significantly during the crisis. While yields for both maturities fell in absolute terms, the decline in two-year yields was more substantial. Given that repairs to the global economy will need to be funded by an increase in debt, the market might be pricing in a rise in interest-rate volatility.

Volatility also reveals itself at a granular level through the daily spread between the best- and worst-performing securities. We interrogate this through the cross-sectional dispersion in equities.

Figure 5: Cross-sectional dispersion of stock returns



Source: Bloomberg, as at March 2020.

What does it measure?

The spread between the market's best and worst equity returns.

What does it consist of?

The daily gap between the best- and worst-performing shares in the FTSE Europe.

How to read it

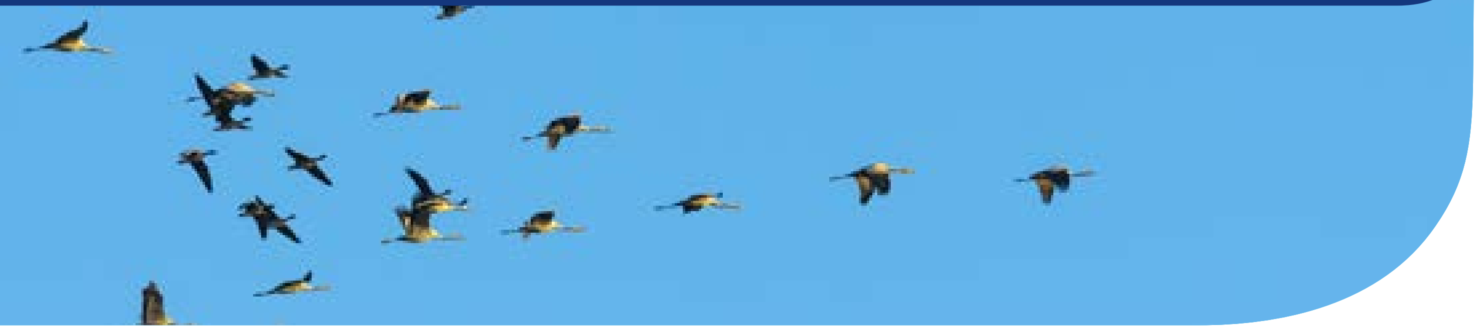
If cross-sectional dispersion is compressed, equity returns fall within a tighter band. A higher cross-sectional dispersion provides more opportunities for stock-pickers to exercise their active-management skills.

What does the latest reading show?

The cross-sectional dispersion in equities has plunged, indicating how equities sold off (and partly recovered) in unison. There is clearly very little dispersion between the best and worst performers – something that is typically negative for stock pickers.

While volatility has descended from its peak, it remains elevated. There is little reason to think that volatility will decline to pre-crisis levels in the near term: markets will remain nervous until improved therapeutic treatments or a vaccine are found, while investors will want governments to indicate how they intend to restore stable economic growth. Change is on the horizon, something that brings with it the potential for increased volatility.

Correlation
Rushing for the exits



In a world of turmoil, everyone wants to leave by the same door – and as quickly as possible. Investors have found few places to hide during the current crisis, except perhaps cash and traditional hedges like gold.

During times of crisis, correlation tends to trend higher and can rise to almost one (which indicates that all assets are moving together). During the recent sell-off, equities across all major markets trended almost identically and correlation rose towards its upper limit.

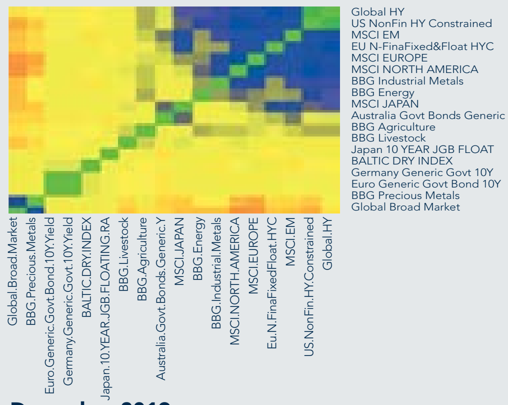
This stands in contrast to more normal markets, when investors distinguish between different scenarios, outcomes and risk appetites and diversify their portfolios across asset classes. As a result, markets tend to move in different directions at both a regional and sector level, which reduces correlation.

The danger of correlation nearing one is that diversification – one of the most important and reliable forms of risk management – becomes almost impossible. As markets begin to recover, correlations should start to fall as investors look at different themes and begin to rebuild their portfolios.

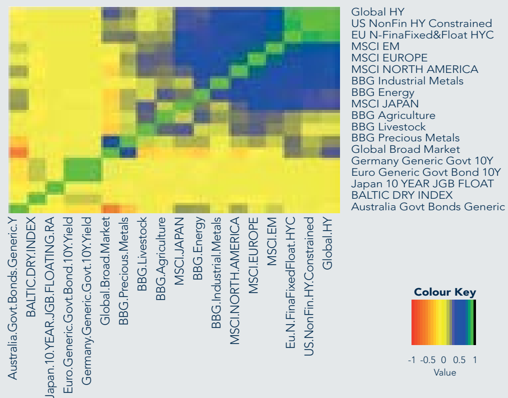
Looking beyond short-term variability, investors also need to understand long-term patterns in correlations and consider what factors may drive asset classes closer together or further apart at any given time. As correlation is based on mean values, we must also account for sample error in our trend analysis.

Measuring correlations among many different asset classes requires some technical, data-heavy calculations. Heat maps offer a simple way to illustrate the complex and changing relationships over different time periods. Here, we look at the correlations between a dozen assets in the first quarter.

Figure 6: Correlation heat maps



December 2019



March 2020

Source: Federated Hermes, Bloomberg, as at March 2020

What does it measure?

The relationship between the returns of different assets.

What does it consist of?

The degree of correlation between the return series of selected asset classes within the quarter.

How to read it

The colour key depicts correlations on a scale from -1 to +1.

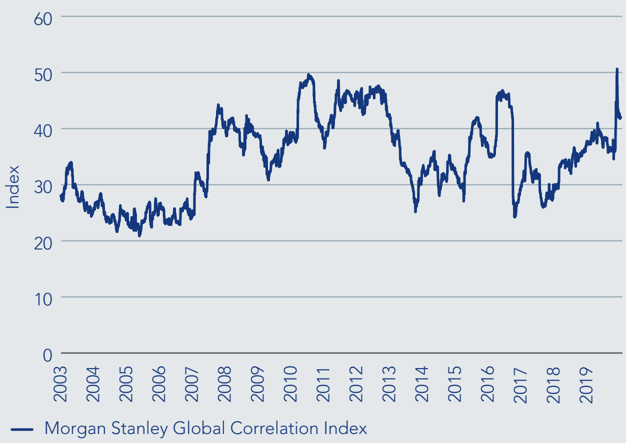
What does the latest reading show?

There has been a subtle but notable rise in correlation across most asset classes, particularly within high-yield credit.

As correlations climb close to one, asset-price swings become more violent

However, heat maps and their limited time horizons can't reveal much about the long-term development of correlation trends. For this, we look to the Morgan Stanley Global Correlation Index.

Figure 7: Morgan Stanley Global Correlation Index



Source: Morgan Stanley, Bloomberg, Federated Hermes as at April 2020.

What does it measure?

An aggregate of global cross-asset correlation over time.

What does it consist of?

Correlations between asset classes, geographies, sectors and factors.

How to read it

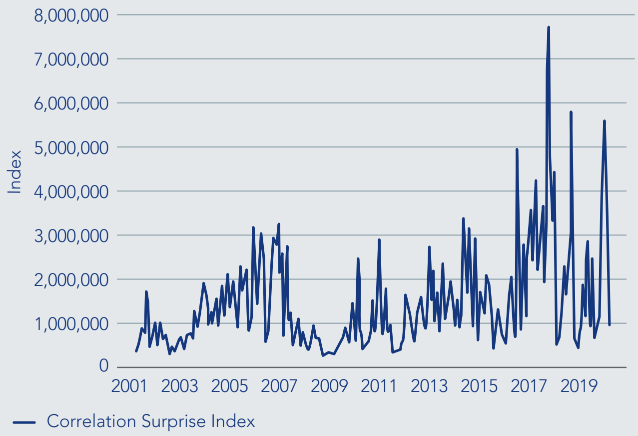
A high reading suggests that assets are more closely correlated across geographies, sectors and factors, and hence will all move together.

What does the latest reading show?

Correlations have been higher than usual this quarter. This has been particularly challenging for institutional investors who seek to build diversified portfolios.

Meanwhile, our correlation-surprise indicator, while not infallible, has previously offered a useful signal of impending asset-class disruption.

Figure 8: Correlation surprise in the global equity universe



Source: Federated Hermes, Bloomberg, as at March 2020.

What does it measure?

Our correlation-surprise measure attempts to capture the likelihood of unanticipated spikes.

What does it consist of?

The returns of five stock market indices are analysed for their 'unusualness'. We then subdivide that measure into a component derived from unusual volatility movements (which we define later as turbulence) and a separate one from correlation movements (surprise).

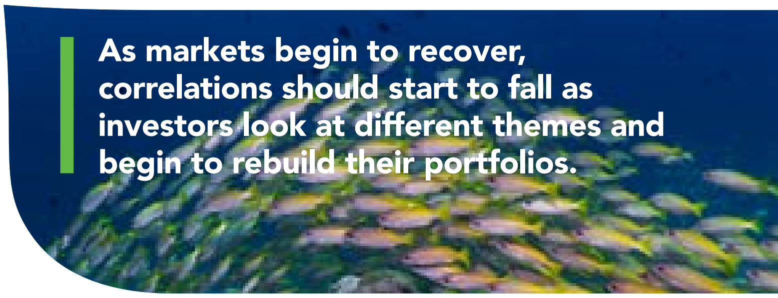
How to read it

Higher levels of surprise predict uncertain times ahead. Spikes in correlation surprise lead on average to poor returns in the subsequent month.

What does the latest reading show?

Correlation surprise spiked earlier this year, reflecting extreme uncertainty. It has since settled down, which suggests that much of the coronavirus crisis has been discounted by the market. It seems the elasticity of the market reaction to poor virus-related news has declined.

As correlations climb close to one, asset-price swings become more violent. While correlation risk remains high, it does offer investors opportunities to diversify their portfolios and reset their risk parameters to profit from positive new opportunities.



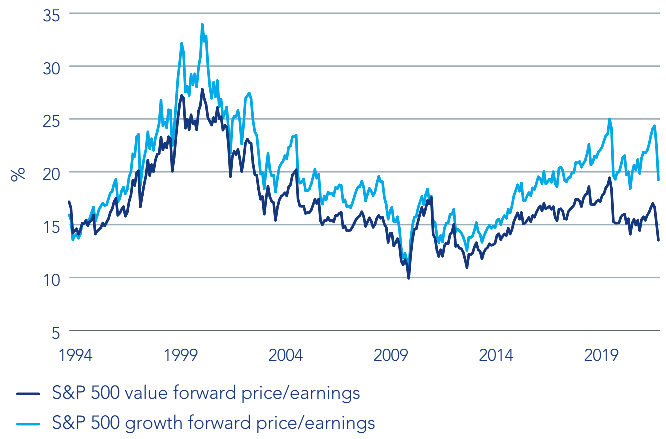
Stretch risk
A yawning gap persists

Stretched assets may sustain price extremes for a while without triggering an uptick in volatility. We use stretch risk to analyse assets that have apparently low levels of volatility or have trended one way for an extended period of time.

We currently see persistent dislocations between a number of asset classes. It seems that fundamental drivers are often overlooked during periods when momentum dominates – like today. This means that mismatches between asset classes can persist for longer.

During the recent sell-off, the extent to which the value style of investing corrected was notable. Growth was slower to react and the gap between the two styles has grown. This suggests that the long-awaited correction in value is not at the forefront of investors' minds (see figure 9). Nonetheless, our quantitatively driven Global Equity portfolio managers note that their quality and value factor has started to perform more robustly recently.

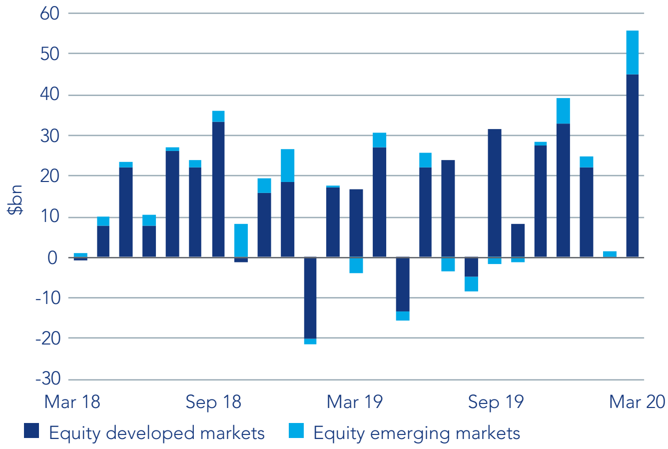
Figure 9. The discounting adjustment is not yet over



Source: Factset, as at April 2020.

There is also a divergence between developed and emerging-market equities. Despite the relative success of emerging markets in managing the spread of the virus – particularly Hong Kong, China, South Korean and Taiwan – investor enthusiasm for emerging-market equities is anaemic at best (see figure 10).

Figure 10. ETF flows into developed and emerging markets



Source: Haver, IIF, as at April 2020.

Investors are unlikely to start looking for relative-value opportunities for some time, although they may start to fish for distressed investments sooner. Rather than pursue a reversion to the mean trade through persistent dislocations, investors are more likely to focus on preserving capital and selecting asymmetric-return opportunities

This may also temporarily suspend the hunger for yield. With valuations dashed, investors might focus on maintaining their portfolios rather than orienting them towards higher-yielding assets.

That said, cash flow is likely to be more critical than ever. This is particularly pertinent given that cash flows from real estate, infrastructure, credit and private equity are hampered. As a result, there may be an increased emphasis on traditional sources of income like high-yield credit.

Liquidity risk
Markets left high and dry

Liquidity risk in markets requires urgent attention. At the onset of the crisis, our fixed-income traders observed that the seize-up in liquidity had created some of the worst trading conditions they had ever seen.

> **While fixed-income markets have borne the brunt of the liquidity freeze, constraints can also manifest themselves in other markets**

The liquidity freeze in fixed income resulted in a rush on higher-quality (and typically more liquid) bonds, while lower-rated credits saw next-to-no demand. We can see this by looking at the Treasury-EuroDollar (TED) and credit spreads, which are two of the most closely followed metrics for funding and liquidity risk (see figure 11).

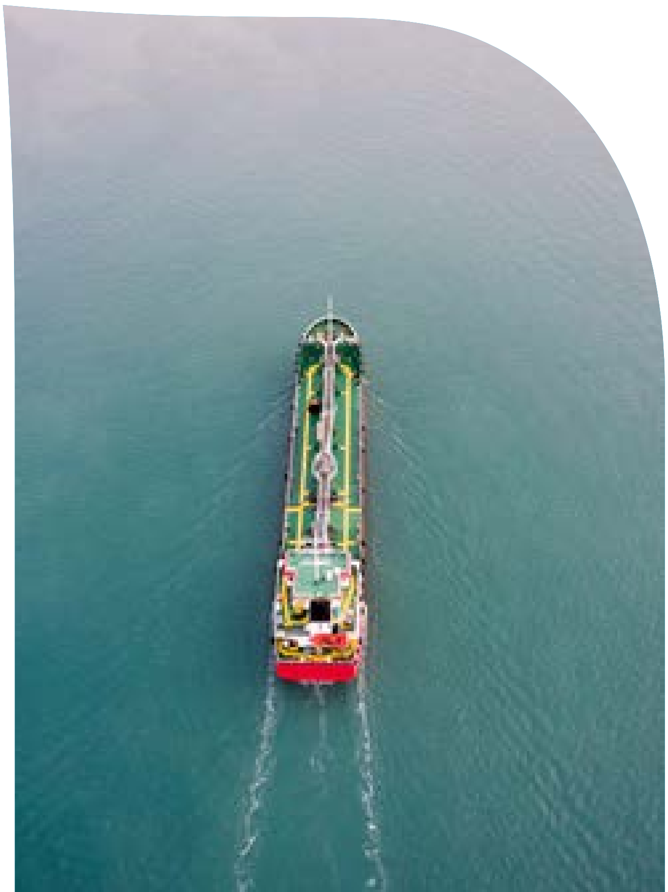
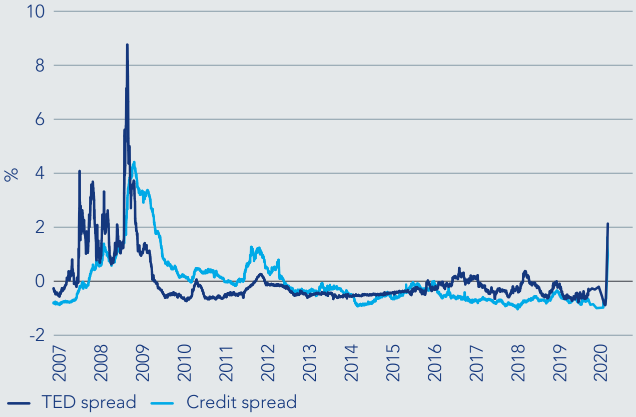


Figure 11: Funding and credit risk



Source: Federated Hermes, Bloomberg, as at March 2020.

What does it measure?

Liquidity conditions in government-bond and global credit markets

What does it consist of?

The TED spread compares the gap between US interbank lending rates and short-term government treasuries, while the credit spread measures the changing relationship between corporate and government-bond spreads.

How to read it

The TED spread is a proxy for overall funding conditions in the economy. The credit spread represents how easy or difficult it is for corporates to source debt from investors. Together they indicate total market liquidity conditions.

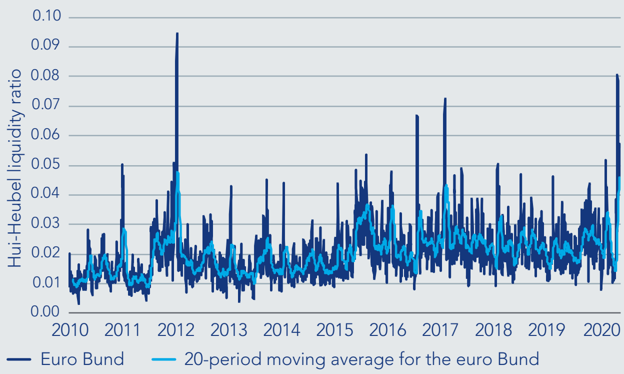
What does the latest reading show?

There has been a pronounced rise in the TED and credit spreads in recent weeks, indicating that fixed-income liquidity conditions have declined.

Last quarter, we noted that fixed-income markets are more efficient at repricing risk than equities and are often the lead indicator of liquidity trends in other asset classes. The sharp divergence in equity and fixed-income liquidity in the past few months suggests that fixed income is once again the leading indicator.

We can also use the Hui-Heubel ratio for Bund futures to look at the state of liquidity in fixed-income markets.

Figure 12: The Hui and Heubel ratio for Bund futures



Source: Federated Hermes, Bloomberg, as at March 2020.

What does it measure?

The ratio measures intra-day price movement relative to the ratio of traded volume to either market capitalisation or open interest.

What does it consist of?

Bund futures are usually extremely liquid, which means that pockets of illiquidity which can act as a harbinger of broader trends.

How to read it

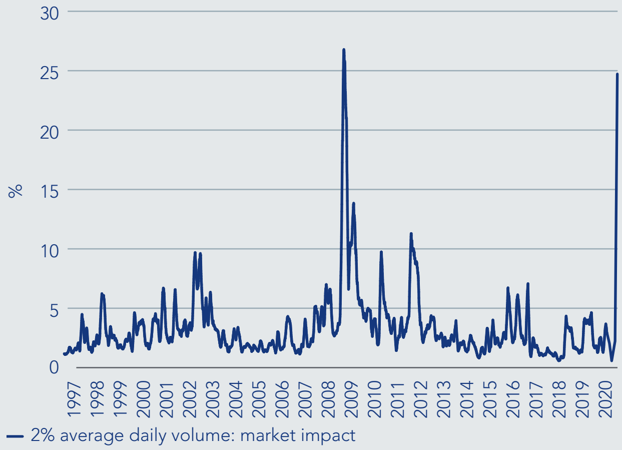
If the volume of trades relative to the price changes is greater, the market is deeper and more resilient.

What does the latest reading show?

Liquidity conditions have clearly worsened in recent weeks. While liquidity is not as poor as it was in 2012, the 20-day moving average is nearing the levels last seen eight years ago.

While fixed-income markets have borne the brunt of the liquidity freeze, constraints can also manifest themselves in other markets – something we interrogate with Kyle's lambda.

Figure 13: Kyle's lambda



Source: Federated Hermes, Bloomberg, as at March 2020.

What does it measure?

Liquidity conditions in equity markets.

What does it consist of?

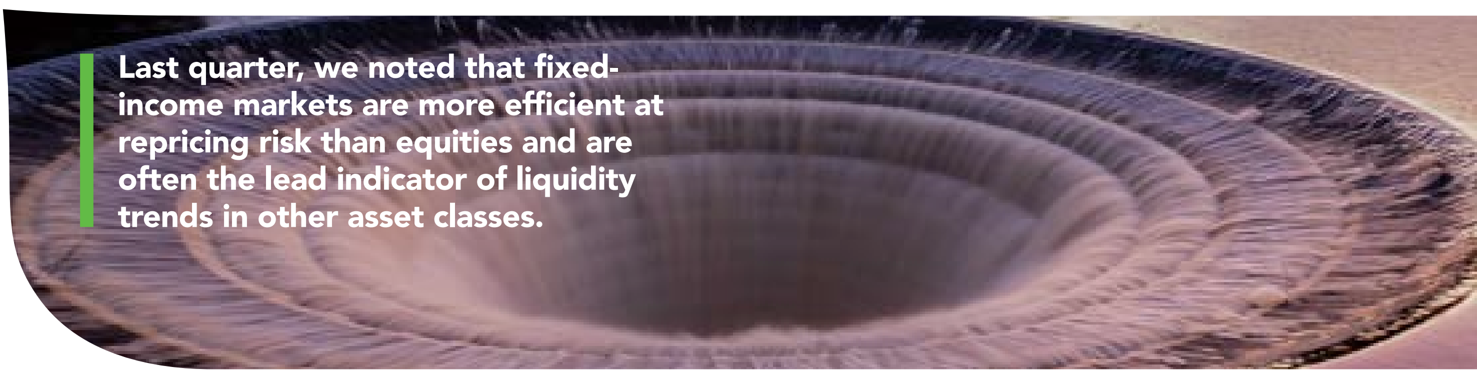
The statistic compares the cost of market liquidity over time by estimating the price impact of a trade that represents 2% of the average daily volume.

How to read it

A low reading shows that a trade worth 2% of the average daily volume has a minimal impact on market prices, meaning that liquidity is plentiful. But if the same trade causes equity-market prices to rise significantly, liquidity is scarce. The five-year average highlights trend movements over time.

What does the latest reading show?

The spike in our model shows that equity-market liquidity has tightened in response to heightened volatility. In contrast to credit markets, our equity traders note that liquidity conditions are manageable at present.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Event risk
A world in lockdown

Geopolitical risks have risen up the investor agenda in recent years. A recent surge in event risk has been driven by rising protectionism, trade tensions, pro-democracy demonstrations in Hong Kong, deteriorating US-Iran relations and the ongoing conflict in Syria.

The latest risk – the coronavirus outbreak – was largely unforeseen, although scientists had warned for some time that a global pandemic was possible. This event was initially contained, but swiftly became a source of mass global disruption.

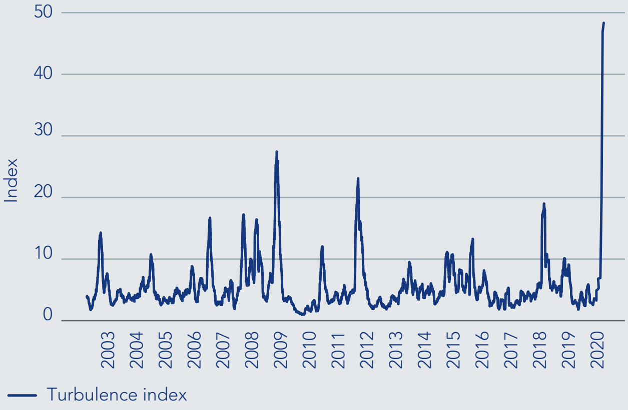
We deem event risk to be urgent this quarter, as the exogenous shock of the global spread of the coronavirus continues to course through markets.

While Chinese containment strategies have been replicated globally, we have seen little global coordination. Even though the threat is universal, geopolitical friction has re-emerged – particularly between the US and China.

With a US presidential election scheduled for November, both Democrats and Republicans are likely to suggest that their opponent has failed to be tough enough on China. It is highly likely that this rhetoric will become more inflamed as the election approaches.

We deem event risk to be urgent this quarter, as the exogenous shock of the global spread of the coronavirus continues to course through markets. We use special statistical measures of market uncertainty – our turbulence index and absorption ratio – to assess the scale of this event risk.

Figure 14: Turbulence index



Source: Federated Hermes, Bloomberg, as at March 2020.

What does it measure?

We analyse market turbulence by identifying how statistically unusual current volatility and correlation levels are.

What does it consist of?

The annualised returns of five equity indices following the most and least turbulent periods.

How to read it

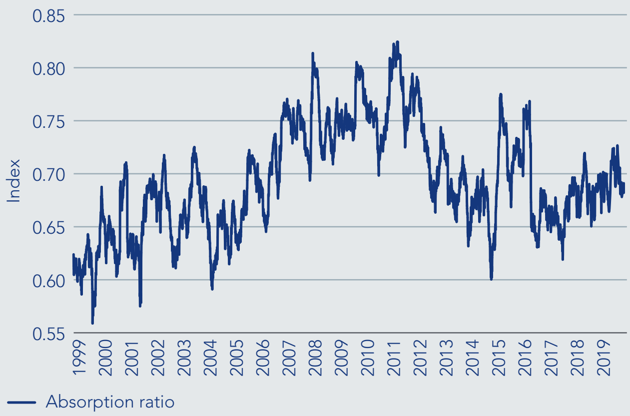
Our analysis demonstrates that the most turbulent periods typically precede significant drawdowns across a number of asset classes and markets. Times of financial turbulence are typically persistent and provide lower rewards for risk-bearing than normal times. As such, this measure could be used to construct portfolios that would be relatively resilient to turbulence via a conditioning process.

What does the latest reading show?

The explosion in volatility and uptick in correlation has prompted our turbulence index to soar.

While the turbulence index tracks the level of uncertainty in equity markets, our absorption ratio takes in a wider vista and more closely approximates systemic risk.

Figure 15: Absorption ratio



Source: Federated Hermes, Bloomberg, MSCI, as at March 2020.

What does it measure?

The extent to which financial-market risk is concentrated in just a handful of factors.

What does it consist of?

We use principal-components analysis to determine the extent to which the largest factors dominate the entire risk-factor set. Our dataset includes information for 17 different asset classes.

How to read it

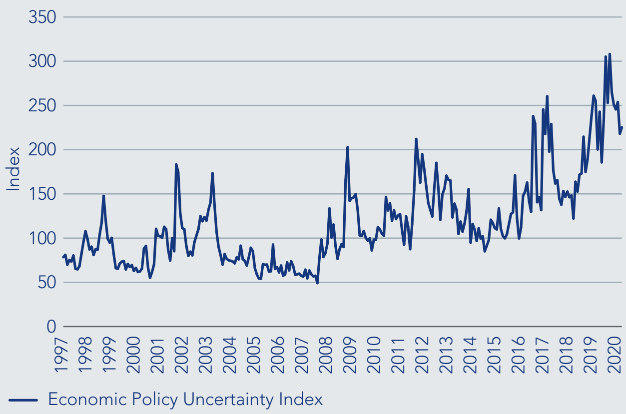
The ratio rises as market risks gather around few factors. When the ratio is high, overall market conditions are fragile and prone to systemic risk across asset classes.

What does the latest reading show?

Although the absorption ratio has risen, it has been far higher in previous years – particularly during the financial crisis. This suggests that a wide and diverse set of risk factors are currently influencing market sentiment.

Finally, we turn to unstructured data to look at economic-policy uncertainty. The tool, which leans on a broad array of traditional and new social-media sources, picks up on underlying changes in the global economic mood that can signal market risks ahead.

Figure 16: Economic Policy Uncertainty



Source: Federal Reserve Bank of St Louis, as at April 2020.

What does it measure?

The level of geopolitical concern in the world.

What does it consist of?

The metric considers global economic coverage to assess the frequency of bad news.

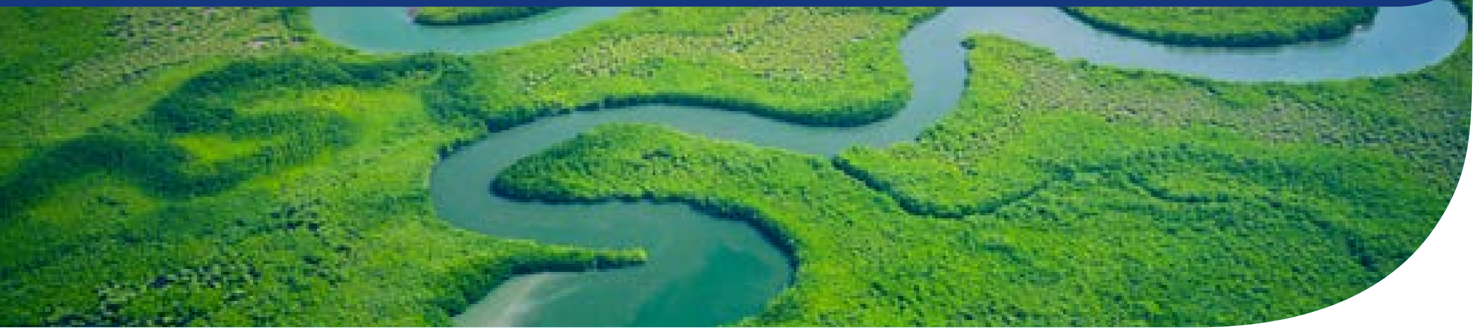
How to read it

The index moves higher as gloomy economic news becomes more frequent. Geopolitical uncertainty is often a precursor to financial market volatility.

What does the latest reading show?

Global economic policy uncertainty rose steadily for much of 2019, diminished slightly at the end of the year and then increased again. The emphatic nature of policy support perhaps removes some uncertainty for now, although it likely does nothing to reduce it in the future.

ESG risk
Embracing the moment of change



Before the coronavirus pandemic emerged, one of the dominant stories of 2020 was the outbreak of the wildfires that had engulfed large parts of Australia, burning 46m acres of bushland and resulting in the loss of over 1bn mammals, birds and reptiles.

Climate activism – led by groups like Extinction Rebellion – also continued in the first quarter. It finally seemed that corporate attention had turned to the concepts of stakeholder capitalism and sustainability after the Business Roundtable redefined the purpose of a corporation as one that promotes 'an economy that serves all Americans'.[4]

The coronavirus pandemic swiftly eclipsed much of the public discourse on ESG issues, perhaps because there was a feeling that mitigating these risks would divert resources from other areas. However, two developments highlight the futility of this attitude.

In March, the UN published a report which described the impact of the coronavirus on the Sustainable Development Goals (SDGs). It argued that the effect of the pandemic on individuals and the world's formal and informal economies would be devasting: it could plunge vast populations into poverty and create famine conditions (see figure 17).

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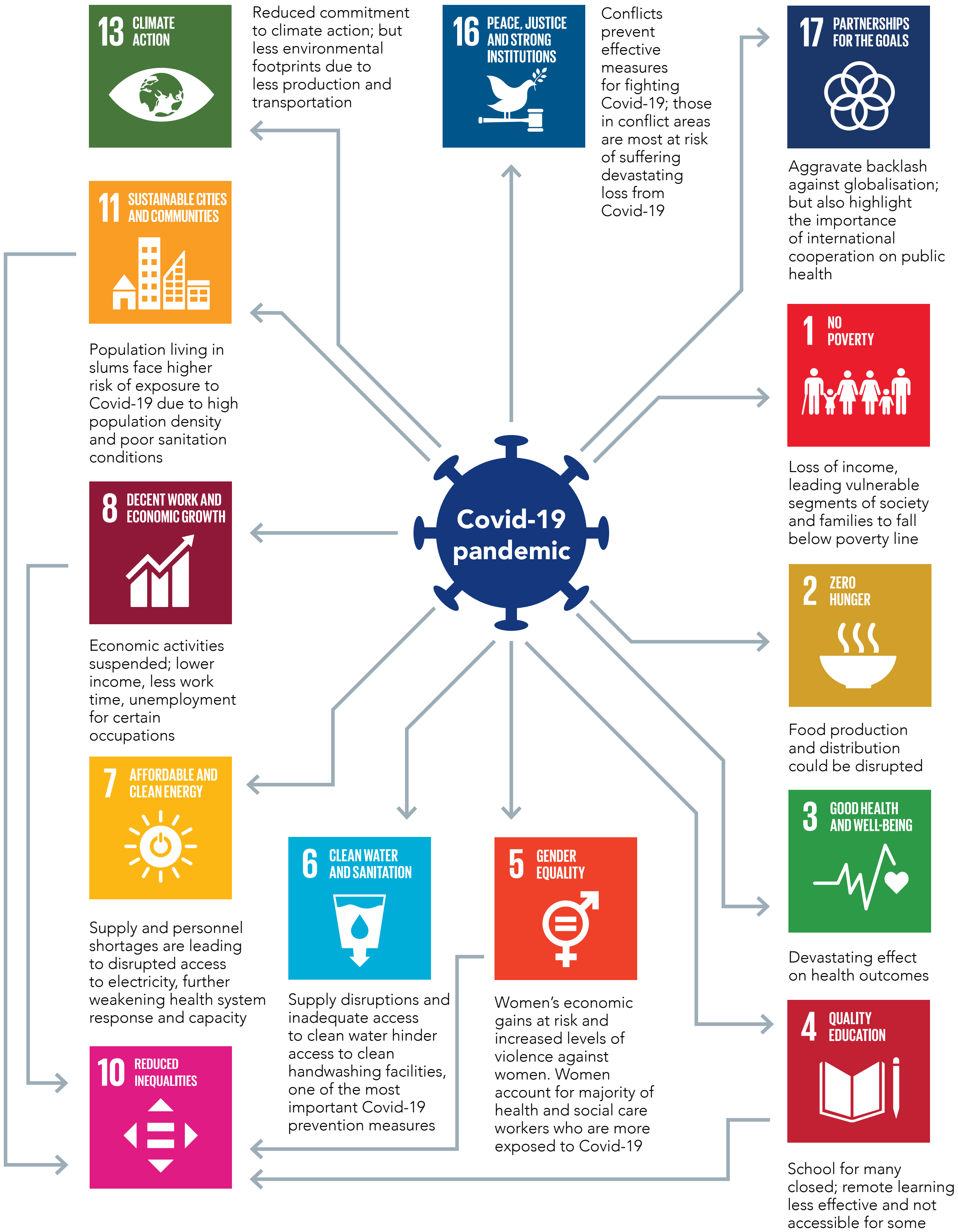
[4] 'Business Roundtable redefines the purpose of a corporation to promote 'an economy that serves all Americans', published by the Business Roundtable on 19 August 2019.

Figure 17. The coronavirus pandemic will affect all the SDGs



Source: UN, as at March 2020.

The UN expects the crisis to negatively impact efforts to implement the 2030 Agenda for Sustainable Development and the Paris Agreement on Climate Change. The pandemic is also likely to exacerbate inequality within society – a grave setback that is impossible to measure at this point.

Yet challenges can also present opportunities. Reduced industrial activity and emissions mean that pollution in industrialised areas has dropped to its lowest level in decades. In India, the Himalayas have become visible from the Jalandhar district of the Punjab, while in Florida, leatherback sea turtles are returning to the closed beaches.

During these trying times, ESG factors are more important than ever and can help bring into focus the changes we need to make to create a more green, equitable society. We have found that companies with strong ESG credentials have outperformed during the current crisis[5], while our Impact Opportunities team notes that companies with a positive impact on society are coming to prominence and flexing their muscles as responsible corporate citizens.

We encourage companies to embrace this moment of disruption and make the urgent changes required. This could be by reducing traffic to urban centres or adopting more social initiatives to reduce inequality and increase opportunities for all. The crisis clearly presents an opportunity to strengthen access to healthcare and promote healthier lifestyle choices like walking and cycling.

Our view of market risk for Q2 2020

In the last edition of *Market Risk Insights*, we warned that markets burn when risk runs out of control. This quarter, we are still in the middle of those flames and have not yet sifted through the ashes. Each of the risks we highlight every quarter have been amplified by the catastrophic impact of the coronavirus pandemic. Now is the time for triage and to prioritise certain risks over others.

Volatility

Triage level: urgent.

The VIX spiked dramatically as the crisis unfolded and remains elevated, although it is lower than it was at its peak. This suggests that markets tend to have longer memories of volatility-inducing events and is a reminder of the legacy of fear that can persist.

Correlation risk

Triage level: immediate.

The recent sell-off has the hallmark of a mass correlation event: the cash-flow impact of the economic shutdown has affected every asset class, from real estate to credit, equities, commodities and infrastructure. We argued last quarter that the correlation regime was poised on the brink of dramatic change and that diversification could prove to be less effective – something that has proved to be the case.

Stretch risk

Triage level: delayed.

Certain gaps – such as the mismatch between value and growth and emerging and developed markets – have been accentuated in recent months. However, the graver distortions affecting markets mean we don't see this as an actionable or urgent risk. Because less attention has been paid to fundamentals, these gaps are likely to persist for longer than might otherwise have been expected.

Liquidity risk

Triage level: urgent.

Market volumes remained solid during the recent rout and subsequent retracement, and equity-market liquidity has stayed robust. The most notable shift was in fixed-income liquidity, which deteriorated rapidly in the middle of March and remains challenged. Given the grave uncertainty surrounding cash flows, we will continue to monitor this area carefully.

Event risk

Triage level: urgent.

The pandemic dominates public discourse, which could shift attention away from actions that aim to suppress the virus. Many nations have adopted special policing powers to enforce lockdowns, while there have been protests about working conditions for essential workers. It seems the fallout from the virus and shutdowns could result in political upheaval in some countries. Meanwhile, geopolitical tension and protectionism remain meaningful long-term issues, but may not receive the attention they deserve in the short run.

ESG risk

Triage level: urgent.

We have previously argued that climate change is the number-one financial risk facing investors. In the medium-to-long term, we still believe this to be true. While the current public-health crisis has shifted the focus from climate-related concerns, the current disruption presents a unique opportunity to start on a different path and pay closer attention to ESG factors.

[5] Calculated by comparing the S&P 500 with MSCI constituents with the highest ESG scores (quintile one). Year to date, as at April 2020.

A global economy on life support

The exogenous shock of a global public health crisis has transformed the economic outlook. A recession is expected at the very minimum, while some fear a far longer depression.

Risks had been quietly piling up in the background before the crisis emerged. Mounting corporate leverage meant there was limited headroom when cash flows collapsed, and investors had little hesitation in taking profits and running for the exit.

Ongoing easing from central banks and the expectation of lower-for-longer interest rates, growth and inflation also meant there was reduced room for manoeuvre when economic stimulus was required. Nonetheless, central banks pledged to do whatever it took to ease the effects of the crisis.

Meanwhile, the swift commitment of governments to soften the blow of job losses and furloughs through subsidies, expanded unemployment benefits and helicopter money may have prevented what would have been an even more catastrophic market fall.

We noticed last quarter that ratings agencies had increased the rate of downgrades in comparison to upgrades – a trend that has intensified over the last few months. This has affected liquidity, as fallen angels have been subject to forced sales. It has also changed the shape of the high-yield market and is part of the reason the Fed decided to include high-yield instruments in its Secondary Market Corporate Credit Facility.

The geopolitical tensions we have noted over the past year continue to simmer and may have prompted the initial lack of global coordination in tackling the pandemic. Tensions continue to brew between the US and China, while divisiveness stoked by Brexit within the European Union may have thwarted coordinated action in securing testing and personal protective equipment for healthcare professionals.

As we look to the rest of the quarter, economies seem just about sustained by government-aid programmes and central-bank support – for now. Yet these measures can't last forever, and some have been running dry sooner than expected – including the US small-business loan programme which required a top-up in a matter of weeks.

How – and to what extent – economies can be revived depends on whether the various infection curves flatten and the readiness of cities and states to conduct the testing needed to safely lift physical-distancing requirements. These are metrics which change by the day. Just as overstretched hospitals triage critical patients, investors must triage the risks to their portfolios and seek to prioritise them.

In this atmosphere of turbulence, it is not an exaggeration to say that we are in the fog of war. It is possible that in a few weeks the fog will clear and the arc of the challenge before us will come into focus – just as the Himalayas have become visible from the Punjab. Without visibility, it is hard to formulate a plan and even the most detailed map is of little use. For now, the focus should be on staying safe, informed and positive.

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