

What's Driving Volatility, and What Could Be Next?

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Chris Hyzy: Hello this is Chris Hyzy, chief investment officer. This is an environment that is highly volatile with frequent wild swings across equities and rates, which also impacts the trends and currencies and commodities just about daily. Capital markets that are dealing with imperfect and uncertain information often remain volatile for extended periods of time as they attempt to price in various scenarios including a contraction in the broader economy, not to mention the magnitude of impacts on corporate profits. We are experiencing known unknowns that are changing behaviors and impacting the economies of many countries. Given the strong state of our financial system and the healthy level of economic activity, led by the consumer, heading into the concerning unknowns, we believe that it is important to understand the similarities and differences versus prior large shocks to the economy in order to assess the timing and magnitude of a potential turnaround.

In addition, in the very short term in terms of daily trading, professional programmatic investors can alter the volatility through short term momentum positioning as markets gyrate. This can create less liquidity and potential gaps in the pricing of asset classes. Therefore, we prefer to stick to the facts regarding the coronavirus developments as they unfold and then assess the economic and profit growth impact over time as more data is released and as possible policy responses are announced. In the coming weeks, we believe investors should consider rebalancing portfolios, which may include more than one episode, as the bottoming process unfolds. This should be done across and within asset classes in our opinion as markets stabilize. At the height of fear such as now, it is important to have investment plans ready and take action according to your stated goals and objectives as volatility subsides.

At present, implied equity market volatility as measured by the Chicago Board Options Exchange (CBOE) VIX index, is suggesting that a reading above 50 indicates that volatility could potentially be plus or minus 3% each day over 30 days. Now this helps describe the level of unknown and often creates price levels that are attempting to price in the worst-case scenarios. Investors should maintain discipline and continue to focus on diversification across and again, within asset classes and let the volatility subside. Market timing is not a successful strategy in our view, rather time in the markets and discipline rebalancing plans when markets overshoot help maintain diversified portfolios for the future. So, let's address the underlying market volatility head on.

With me here to discuss all of this including potential policies responses, the similarities or differences to prior highly volatile bear market times and some portfolio considerations for individual investors are Mark Cabana, head of U.S. Interest Rates Strategy for BofA Global Research; Michele Meyer, head of U.S. Economics for BofA Global Research;

Savita Subramanian, the head of U.S. Equity and Quantitative Strategy and ESG Research for BofA Global Research; and finally, Michael Hartnett, chief investment strategist also of BofA Global Research.

So let's start with the volatility and let's start with Mark. Mark, can you in your view of what you've been witnessing recently, as well as a lot of the work that you've done regarding the underlying market volatility, particularly in the fixed income markets, can you describe what's going on?

Mark Cabana:

Sure, happy to. So, the Treasury market has been highly volatile and this has resulted in a notable deterioration of market functioning and liquidity in not only the U.S. rates market, but also other interest rate markets. Now, I typically think of the U.S. Treasury market as being one of the bedrocks of the financial system upon which other asset pricing is based, and we have seen some very, very wild swings in the US Treasury market over recent days. The amount of realized volatility at least looking at a two-week rolling standard deviation of daily changes in 10- and 30-year treasuries, is about 17 or so basis points a day and this is on par with what we saw during 2008 in the financial crisis and around the levels that we saw in 2011 when there were very real concerns about a breakup of the European Union. This type of elevated volatility has led to market makers widening bid offer spreads, requiring more compensation in order to facilitate market flows and has generally led to underlying illiquidity in the Treasury market. That is not a very welcoming sign when there are large discussions about how the US Treasury is going to need to fund likely some sizeable additional fiscal stimulus in order to address underlying public health concerns stemming from the coronavirus.

Now, there's been a lot of talk about what type of policy options could be used to stabilize the rates market. There are a number of things that the

U.S. Treasury or the Federal Reserve could do, but at the moment, the market has really been left for any type of direction from these public policy officials and there's been no clear plans articulated. That has led to an increase in underlying volatility and just today, when we see the equity markets, at least at the moment, down somewhere between 7.5 to 9%, U.S. treasuries have sold off about 10 or 13 basis points intraday and they're now pretty close to flat on the day largely because there's an upcoming treasury option that investors need to position for. Certainly, when you would see equity markets down by this extent, you would think that treasury securities should be rallying, but it seems like liquidity concerns are at least overwhelming the U.S. rates market for the moment.

Chriz Hyzy: Let's continue on that liquidity and volatility theme and we'll shift quickly to the equity markets and we'll start with Michael and then go to Savita. Michael, can you give us a feel for what is being experienced right now potentially versus prior times?

Michael Hartnett: Sure. I think, Mark, pointed to the U.S. equity markets experiencing you know really a historic loss today. I think at one point the Dow Jones was down more than 9%. And you know where it's closed down 9%, really there's only been three or four days in the history of the equity market where you've seen a bigger one-day decline. One of them was in 1987 and the other two or three were during the 1929 crash. So, it truly is a historic day that will be remembered for a very long time. And when equity markets are experiencing losses of that degree in such a short time, it's because investors are fearing either: a) a recession, or b) a crisis event, or c) a policy response that's inadequate. Quite honestly, Chris, it's all free at this particular moment and so to restore order and stability and confidence, I think as Mark touched on, you need leadership, you need policy leadership, and it needs to be coordinated, it needs to be determined and it needs to be large and one fact emerged and it will emerge because it

always does and the markets will ultimately force the issue; stability will be returned, the volatility will come back down. But right now, the markets are very impatient for a much more mature response than we're seeing from the policy makers. That's why the volatility and the losses are just so high.

Chris Hyzy:

Excellent. Savita, let me have you round out this first section as it relates to coming out of this. If the assumption is policy responses are likely on the way and they're talked about daily – and we'll get into that in a minute as well. Coming out of this, looking at corporate America, looking at the U.S. equity market, what are you looking for and what is likely to occur back half of the year into next year as cash flows begin to build again in your opinion?

Savita Subramanian: Yes, it's a great question. So I think the impact of lost business, of lost travel, uncertainty has already been profound. But I think the snapback on some kind of resolution or containment of – or at least a deceleration in some of the – the economic barometers could actually drive a reasonable kind of pent up demand, snapback in the second half of the year. Now, I think where we're more constructive is on manufacturing activity, whereas you know loss services from restaurants, travel, vacations, business travel, those are not going to be recovered anytime soon. Those are not recoverable costs. So, I think that that's where we could see this meaningful snapback is on the manufacturing side. You know I do think so that there are reasons to still remain constructive on a large bulk of equities that have been summarily sold off.

One of the things that we've been looking at or just this down turn, we've seen stocks behaved uniformly. There's been no sort of differentiation between stocks during the selloff. And, in fact, this selloff has been much more a story of uniformly discarding all equities that we've seen in prior

sell offs. So, I think this leaves investors with is an opportunity to think about the potential recovery and here we could find a really good entry point for a lot of stocks. Our analyst within our research department has been very aggressive in highlighting those. Again, thinking about this from the perspective of things are going to get worse before they get better, I think a lot of stocks right now are actually reflecting meaningful recessionary backdrops which may or may not play through. These companies could be some of the best buys if you think about a longer time horizon here.

Chris Hyzy:

If you have time, can you take us through a little bit about of what you are thinking about in terms of the economy, both through this tough period and then coming out. And, a lot of people talk about the shape, a U-shape recovery, a V-shape, a W, an L. Can you also address that?

Michelle Meyer:

Sure. Absolutely. So obviously, try to understand the trajectory has been challenged because of a shock that is unlike what we've seen before. In terms of not only has it clearly impacted market conditions and created a negative wealth shock, and led to what has been some financial market instability or dysfunction of – Mark has been alluding to. But it's also changed behavior and confidence, people are fearful in their responding. So what does it mean? What do we think the trajectory will be? You know we would argue if it's more U-shaped in nature, but it's a prolonged U. So the bottom could be a bit deep and a bit persistent as well until we get to that other side.

So when you look at our GP forecast for this year, we only have 1.2% growth that's considered "growth recession." So, it's below trend but it's not our right contraction. But we think, in the second quarter and the third quarter of this year we're going to flirt with falling into recession. So, we'll probably have close to zero growth between those two quarters,

potentially a negative quarter there. That's because we think we're going to see some pretty significant shift and how consumers and businesses are engaging. Each passing day we see more businesses shut their doors, people are working from home, consumers are continuing to stock up and reduce spending on discretionary items.

Certainly, travel related spending was the area that got hit the hardest and most acutely – but the risk now is that it's spread more. You can look at what's happening internationally to get an idea of what might come here in the U.S. You do make those comparison, you start to really think about quite a difficult time economically in the next few months. That said, when you look at the international comparison particularly, China, you could also start to see the other side. Once the virus is contained, which we have to hope could happen in so much short order, there will be pent up spending, there will be pent up demand, pent up investments and the economy can come out of that, but it will require the appropriate policy response to get us to that other side.

Chris Hyzy: Thank you, Michelle. Let's talk about some possible policy responses, much has talked about on the monetary side. There's a combination potentially on the fiscal side. What's actually realistic in your view that we can expect potentially in the very short term?

Michelle Meyer: I think the best thing by far, is a One-Two Punch monetary fiscal policy. They both need to address the crisis. They to work simultaneously and address different parts. So, when you think of monetary policy, you know the set of course is already kind of interest rate at 50 basis points. We think that'll be it to zero or lower bound in short order, but it's not just about interest rate policy. Interest rates help in terms of debt service that's really a blunt instrument right now. We think they will continue put in place policies like they are right now this morning as Mark is addressing

around supporting market functioning, helping a funding market, putting in place this liquidity type program. Mark and I co-authored a piece yesterday called the Fed's tool kit where we looked through all of the possible tools that they can use; non-traditional tools that they potentially can use and we think they will we employed. But definitely that's only one part of it; that's to make sure that credit can flow through the economy and that there's a right price for that credit.

Ultimately, what I think could be even much more impactful would be fiscal policy, that can prove to be much more targeted, it could address the parts of the economy that have been hit the hardest from this crisis. So there's a number of bills that are under review right now in Congress; payroll tax cuts seem to be something that the President is calling for. We've seen that in the past. It was used last under president Obama in 2011, 2012. If you have a 1% point reduction on payroll taxes, for example, if that's 65 billion per year of additional income that goes into consumers. Payroll tax cuts are – you know they're fairly slow to be realized and again, they're not really targeted. So, in our view a better program would be to focus on automatic stabilizers.

So right now, we have unemployment insurance programs that automatically kick in when one loses a job, but what about programs that help people who don't have paid sick leave? What about programs that help people who have seen a reduction in hours worked as a result of this crisis, particularly in leisure and hospitality and services industries. Can you create [some source] facility that directly puts money into the pockets of those individuals that are not salaried workers and are budget constrained and are really working hard to address this issue?

Direct funding for healthcare as well to help people fight the Coronavirus and get the appropriate tests and the appropriate care. Small businesses

that are going to see a loss of revenue as a result of it; might have challenges meeting their debt – servicing their debt, some sort of credit extension to them as well. So, I think if we start to see greater progress towards those targeted fiscal programs that are happening simultaneously as monetary policy, I do think that that could go a long way to stemming some of the panic and helping to get some sense that there is a recovery on the other side.

Chris Hyzy: Great and Michael, you've often talked about coordination. Can you talk about it and take us around the world in terms of what coordination you think is needed? At least while we're going through the depths of – or at least the highest points of fear at this point?

Michael Hartnett: Yes. Sure. The policymakers around the world, I mean they're already reacting to what is likely to be a recession in China, a recession in Europe and perhaps a recession in the U.S. Obviously, the policy action is designed to you know try and improve business and consumer confidence, facts such that the recession is very short lived and doesn't end up being deep and you know have a permanent hit in society. Often, you find that these moments when you have contagion when the credit markets effectively closed. Things spiral out of control very, very quickly and you can also have a very quick knock-on effect into the real economy.

There have been moments in the past: 1987, 1998 where coordinated action across central banks, was very effective at short circuiting the potential negative feedback loop from asset prices into business and – consumer confidence, of course, there are other moments – 1929 and 2008 where policy makers were not so good at averting that contagion from Wall street into Main street. So, what we'll look for is, as I said, a big policy response that needs doing – include the Fed, it needs to include the ECB, it needs to include the People's Bank of China, it needs to be global,

it needs to address the problems in the credit market, it needs to address business and investor confidence.

But again, as Michelle says that the other wheel of the bicycle has to be fiscal policy, and you need to see announcements of much greater spending on the problem which currently is the Coronavirus, but secondly, again, addressing small and medium sized businesses that potentially could be huge employers in Europe and the U.S. and preventing them from laying people off and you start to get a spiral down within the economy. So, it really has to be both. Again, when there is fear and loathing, coordinated policy, boy, can it be effective. But, you know, you need the people in power to coordinate and, thus far, we haven't seen a lot of that.

Chris Hyzy:

Yes. Speaking of policy of responses, we can get into what the most recent Fed announcements were regarding potentially starting purchases. We're starting to see a reaction in some of the markets to the positive right now. I want to circle the wagons a little bit here and finally with Savita. Michelle mentioned the possibility of a longer U-shaped type recovery coming out of this. Can you talk about how that may or may not filter into some earnings assumptions?

Savita Subramanian: Yes. Let's talk about earnings. I think, as I said, the earnings impact is already pretty significant. So, I think all told with this sort of U-shaped recovery scenario, we would be looking at a lost year of earnings, and we actually had a lost year of earnings last year as well. We had flat growth last year. We could track another year of flat growth. I think what to watch is just how the uncertainty translates into waning business and consumer confidence. We've seen strong evidence in our credit card data that Michelle and I track of stockpiling, so there are areas where consumers are amping up consumption, but then, of course if you look at travel and

business activity restrictions overall, those have contributed negatively to earnings. We've actually lost about \$8.00 of S&P earnings from just travel, restaurant, business activity restrictions, et cetera. So, I think that with lower oil prices, a stronger dollar, supply chain disruption, could all drive us to a flat year of earnings growth. I think the other aspect to watch is just how lower oil prices translate into credit events. We're seeing this within the energy sector. We're seeing credit spreads spiking, we're seeing companies cut their dividends. So, I think that's the other key component to watch from an investment perspective is just the safety of dividends.

Now, to put this into perspective for the S&P 500, the good news is that even if we saw a dramatic decline in earnings. So, think about it, during a recession, earnings typically drop by about 20%. But, even in that scenario of recessionary earnings drops, the dividend safety of most pockets of the S&P 500 are actually very strong, and what we calculated was that even in the 20% cut to S&P earnings, the actual payout ratio of the S&P would only breach 50%; only half of earnings would be paid out as a dividend, which is actually the long term average. So, the good news is the companies are actually, today, paying out a lower percentage of earnings of the dividend than they have historically. So, even in a downturn, we think that many of the sectors of the S&P can maintain that dividend. I'm talking here about healthcare companies, technology companies, even financials, which have lower payout ratios, stable earnings, and could survive even in an earnings recessions. But I think, again, what we want to watch are areas that are more likely to cut their dividends, like energy, select industrials companies, troubled consumer discretionary companies, those are the areas that we really want to watch to see whether that dividend is sustainable.

But, you know, just to sort of kind of put this into context, I think the one reason that we're still very constructive on the S&P 500, is that the yield

on the S&P 500, the dividend yield on the S&P 500, is over four times that of treasury bonds at this point. This is a new income world that we live in where we haven't seen this relative attractiveness of S&P dividends since the 1930's, so I think that it's important to keep in mind that while some companies are cutting their dividends, the overall profile of the S&P 500 from a dividend preservation perspective still looks relatively attractive.

Chris Hyzy:

Excellent point, Savita. As we would have it in terms of what we talked about the fluidity of data, and Michelle touched on this before and so did Mark, as well as Michael and yourself, the policy response recently as of just a few minutes ago by the Federal Reserve in terms of improving liquidity, is the first step or appears to be the first step of potentially many to improve confidence very similar to what was described at the outset of this call. We're going to switch to the final section at this point, and it's really about the individual investor. I want to start with Michelle regarding the economy. What signs should an individual investor look for and keep clues on to give us a better feel that indeed a recovery is afoot as we look out over the next few months?

Michelle Meyer:

Unfortunately, it's going to be hard to see that in the typical data that we would track. The economic flow of data is going to be quite lagged. So, I think you know for me, personally, I think this probably would be reasonable for others' to track as well. It's more you get a sense of the high frequency indicators. So, our companies still actively closing, can you start actually talking about businesses feeling more comfortable having their workers to come back, simply tracking the flow of the virus. Are we getting close to the point where we're at peak rate for the coronavirus or are we seeing a slowdown in the number of people who are contracting it? Is there any sense that people are returning back to more normal behavior? Unfortunately, at this point, I think we're far from that. We're now in the early stages where we're first starting to see the shift in

how businesses are acting and how consumers are acting. We're going to be in the point where people are increasingly self-quarantining and non-engaging in the economies they normally would. But I think when that shifts, when you start to see more movement in the economy, people out and about, and it will kind of just be a sense, then you know that the recovery is here. But, again, it's not going to show up in the typical non-farm payroll numbers or the Census Bureau's retail spending data. It's more of these high frequency indicators, many of which are more anecdotal than anything else.

Chris Hyzy: All right. Thanks, Michelle. Savita and Michael, let's switch to you in terms of individual investors and thinking about diversification and thinking about panicky times. Can you take us through your thoughts on that starting with Savita and then ending with Michael?

Savita Subramanian: Sure. Yes. I'll keep it simple. I think panic selling in our work has been a recipe for underperformance. A couple of things to keep in mind; thinking about the market since the 1930's, if we had sat out the 10 best days each decade, returns would be 91% in the S&P 500, versus what we actually got from being invested over the last 100 or so years of 15,000%. So, 91% from missing the 10 best days versus 15,000% for just sitting it out, riding it out and remaining invested. I think what's also important is that the best days of the market tend to follow the worst days. So, market timing is actually a very perilous exercise, and I think that that's one thing to keep in mind is that emotional reactive trading is generally a bad idea.

The other kind of really remarkable thing about the equity market is that time is essentially money, and the reason I say this is –we sounded as investment time horizons lengthens, the probability of losing money and stocks really falls, and other asset classes don't necessarily support these characteristics. So, for example, if you look at commodities, the

probability of negative returns over a 10-year period is about 40%. For stocks, the probability of negative total returns over 10 years is just 4%. So, our view is be selective, think about quality and safety of yields, but avoid panic selling and take a longer view on stocks. Again, the probability of negative returns over a 10-year period is just 4% for the S&P 500.

So, we're basically proponents of having a high quality, kind of a more defensive bias in our holdings, but panic selling has generally been a recipe for underperformance.

Chris Hyzy:

Thanks, Savita. Michael, just to cap this off with you; you've done a lot of work on obviously, as we mentioned before, prior panic and bear market type of episodes. All of which have their own element to them but can you give us some final thoughts on what the individual investors should pay attention to that you think about as we're going through this?

Michael Hartnett:

Yes. I think, firstly, you always want to stay disciplined. You always want to stick to whatever your methodology is, the asset allocation that you agree with your financial advisor. You don't want to distance yourself from that, and in a quick way, it always is important to be diversified. Probably more so going forward given that over the past 10,12 years you've seen such excess returns from both equities and corporate bonds relative to 100 years of history. Meanwhile, things like cash and gold, and commodities have been much worse in terms of their returns over this period. So, you know, going forward, I think that asset allocation that's much more diversified is important. I think secondly, quality – again, I think, as Savita points out, tends to work very well over the long term. We sort of coined a phrase best of breed stocks. You want high quality stocks, good management, good balance sheets, good you know products over the longer term, those companies will grow and those are the companies that

will give you the best return. It's been that way thus and I think it will continue in the future.

And then the last thing I would say particularly for clients based in the US is do you think about the dollar? I mean, often you've found historically when these moments occur whether it's the 1929, '87, 2001, when you had these exogenous shocks, ultimately, when interest rates come fall enough, the dollar has to take the strain. So, I do think going forward, one of the leadership changes that you may find after this event is that there's been a lot of money that's poured into the US in the past 10 years. It's been the safe haven. Now, I think, unfortunately, what's going on in the credit rock markets will remind people that, again, from a global perspective, they need to be a little bit more diversified, and that means a weaker dollar.

Chris Hyzy:

I want to thank Michelle, Mark, Savita, and Michael, very much for all of your insights and, certainly, opinions as we get through some very difficult time. In fact, today, at its lows, we approached the worst one-day decline since the 1987 crash. So, thank you all very much for your time.

To close, I want to think through the unknown and what is most likely to unfold later this year and, more importantly, longer term, in terms of what we all just discussed. We expect short term market volatility to remain until improved data develops regarding the coronavirus and policy coordination in responses are released. At this point, we expect the markets to stabilize and begin to focus on the recovery versus what the current focus is which is on the unknown. We would rebalance portfolios as the volatility begins to recede. We are not there yet at this time. Any stimulus placed into the system in the 2020 shock year is difficult to remove until the economy is on much firmer ground. We expect stimulus to move from cushion status to tailwind later in the year to help support

the economy. This should help corporate cash flows recover in time which we expect to help high quality companies reprice upwards also over time. Equities have become more attractive in absolute terms and much more attractive in relative terms given the collapse in yields and the correction in the price earnings multiple of US equities. So, growth investing remains at this point and we expect it to remain as well in the longer term. But, now, total return dividend based investing as highlighted by Savita is on equal footing in our view. We would stay balanced and also use allocations to defensive sectors to increase diversification.

On the fixed income side, particularly treasuries, in our view, they still remain a risk mitigation portfolio solution versus equities but they are potentially vulnerable to sizeable backup in yields once the recovery begins to materialize, the shorter end of the yield curve is more attractive from our perspective. Investment grade, high quality is still preferred versus high yield.

Last but not least, some long term thoughts. In the coming years, the virus spread and oil price war are expected to accelerate the impact of the 2018-2019 trade and tariff war to a major change to the global supply chain. On the behavioral side of things, potential changes are likely to include a greater awareness to health and wellness. An expansion of the experiential culture that began to build some few years ago. The greater use of digitalization and virtualization, an increased focus on risk mitigation practices, waste management, climate control and infrastructure investments, as well as potential new capital expenditures and new productivity initiatives in our opinion. A demographic wave is also likely to increase allocations to equities in search of total returns given the record low yields in fixed income as an entirely new business cycle begins to develop. Last but not least, focus on diversification and have plans ready as the uncertainty ultimately begins to fade. Thank you.

Operator:

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