Graystone Consulting
A business of Morgan Stanley

Apply Established Investment Approaches to Manage Market Volatility Despite Unique Catalysts

March 2020

JODIE M. GUNZBERG, CFA
Managing Director,
Chief Investment Strategist
Graystone Consulting,
a business of Morgan Stanley

We will likely look back on the week ending March 20, 2020 as a historically critical week where policymakers realized coronavirus is not just a major health crisis but has caused a massive economic crisis that was exacerbated by a spectacular oil price decline. Therefore, extraordinary sets of policy actions were put in place that were reminiscent of the global financial crisis with the Fed injecting $1.5 trillion[1] of stimulus to address plumbing issues in the operations of the financial sector.

The S&P 500 dropped 31.9% from February 19, 2020 to March 20, 2020, after its 4th biggest 5-day weekly loss of 15.0%. The last time the S&P 500 had a week that bad was the week ending October 10, 2008, and the last time the index fell as much in 22 trading days was in the period ending on October 5, 1931, during the Great Depression.

Also volatility has soared in the S&P 500 with 9 of the last 10 days moving more than 4% in either direction, which is a first in the history of the index starting on January 3, 1928. The 30-day volatility of the S&P 500 is now at 74.2%, a dramatic increase from its level of 11.8% on February 19, 2020. The last time volatility increased this much so quickly was the period ending November 16, 1987. There have only been periods with volatility this high in 1929, 1931, 1932, 1987 and 2008, and on average the volatility has lasted about 20 days with highest recorded volatility of 96.5% on November 28, 1929.

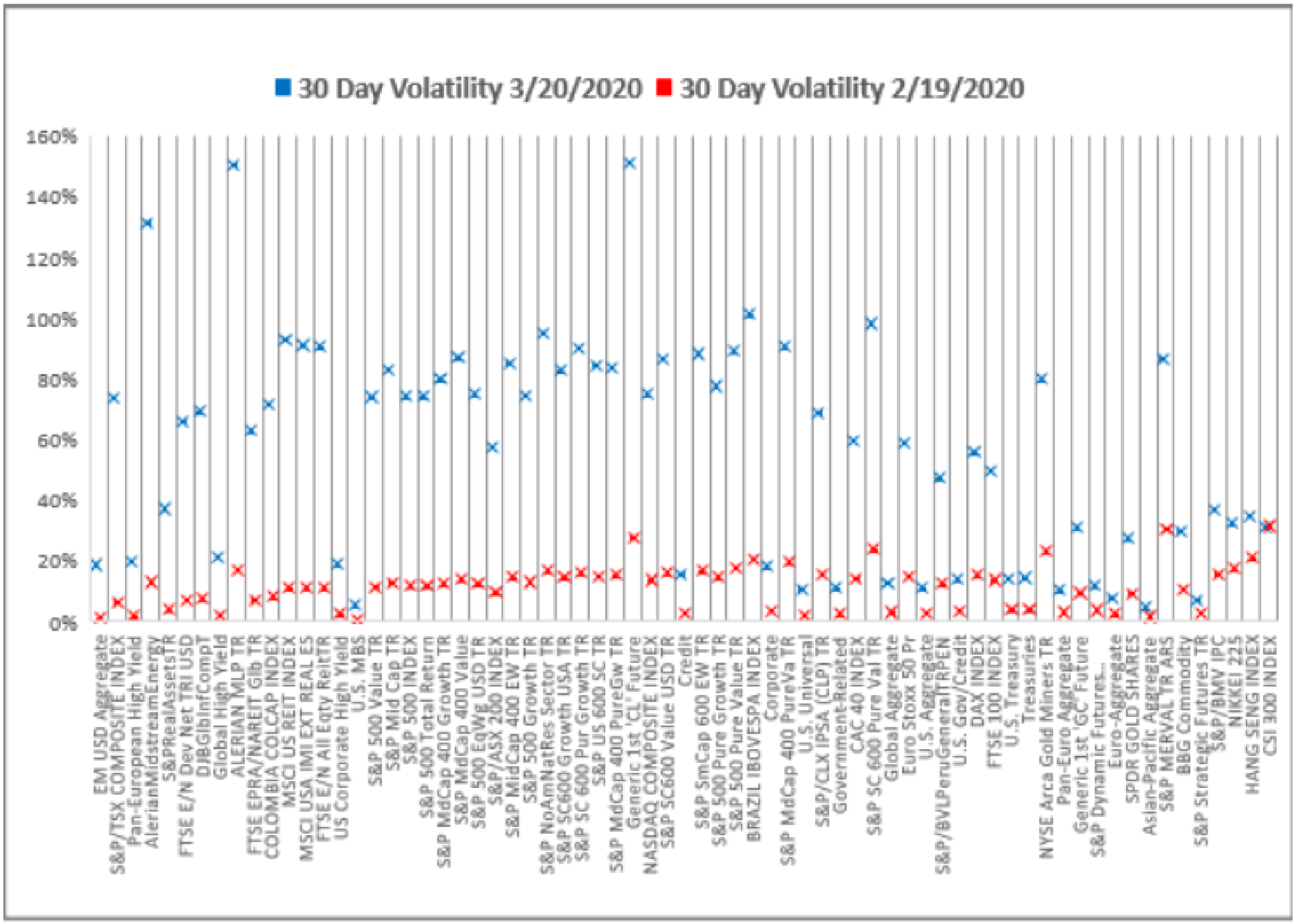
Notes:
[1] Reuters, March 23, 2020, A 'bailout' for Main Street? Fed says it is on the way.

In addition to the stock market volatility, oil prices have gotten hammered in the battle for market share between Saudi Arabia and Russia. Oil dropped 62.1% from its peak of 53.8 $/bbl on February 20, 2020 to 22.4 $/bbl on March 18, 2020. While oil's worst week ended down 29.5% on January 18, 1991, last week was oil's 2nd worst on record, contributing to its fastest decline ever, and lowest price since March 1, 2002. The combined impact of the coronavirus halting economic activity in its tracks and oil's free fall roiling credit markets could have been tipping points for any economic expansion, but especially one that was arguably approaching the end of its cycle already.

The Fed has stepped in to provide liquidity in the fixed income market that has become extremely illiquid. Both investment grade and high yield option adjusted spreads are wide at respective levels of 3.87% and 10.09% that are highest since 2009. However, we continue to see new issuance, and credit is starting to look more attractive, particularly for investment grade bonds where the chance of default is low, which can be beneficial especially for defined benefit plans since there aren't many attractive long duration assets to purchase.

In this time of market distress, volatility has dramatically increased across asset classes. Some assets have more than 10x the volatility they had just 22 days ago. For example, the EM USD Aggregate volatility increased from 1.2% to 18.8%, the S&P/TSX COMPOSITE INDEX volatility spiked from 6.5% to 73.8%. Even the S&P Real Assets index, a mix of stocks, bonds and commodities increased its volatility 9.5x from 3.9% to 37.2%. Note in Exhibit 1, the spectacular volatility increase across the market from February 19, 2020 to March 20, 2020. While oil's volatility increased to 151.3% from 27.8% that was only an increase of about 5.5x – less than the 6.3x volatility rise on the S&P 500.

Exhibit 1: Volatility Spikes across Asset Classes from February 19, 2020 – March 20, 2020



Source: Graystone Consulting, Bloomberg. All Indices are unmanaged and not available for direct investment. Past performance does not guarantee future results.

Naturally some the assets with higher volatility velocity have also experienced some of the more severe declines since February 19, 2020. However, the most battered assets include energy, value and mid-small stocks. The energy companies could not escape the oil price drop and larger companies can generally better withstand the slowdown. On the other hand the managed futures strategies have done well given their long/short trend following systems, and US treasuries held up.

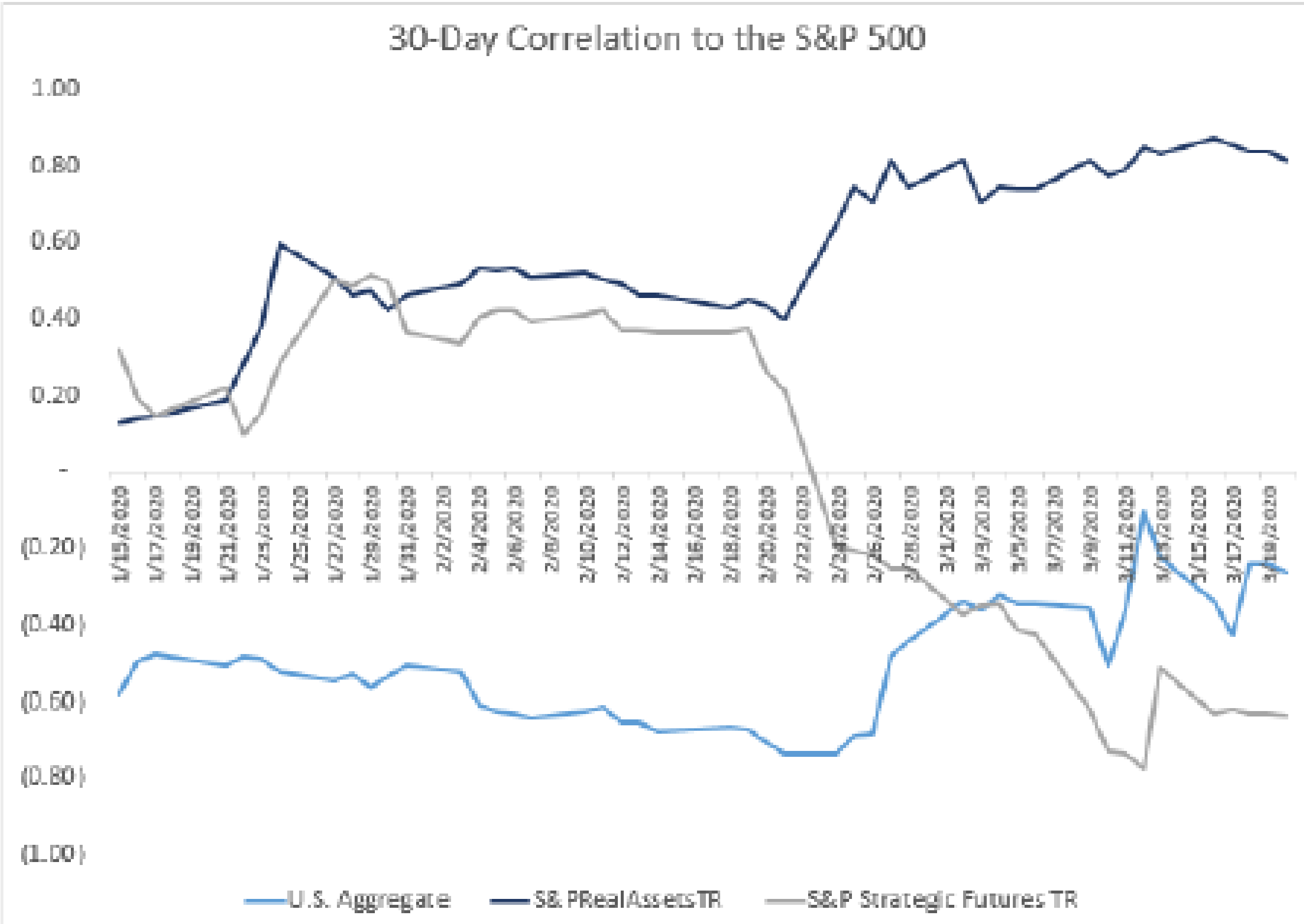
Exhibit 2: Returns across Asset Classes from February 19, 2020 – March 20, 2020

Return from 2/19/2020 - 3/20/2020					
Generic 1st 'CL' Future	-57.5%	FTSE E/N All Eqty ReitTR	-37.8%	BBG Commodity	-20.2%
ALERIAN MLP TR	-54.8%	S&P MdCap 400 Growth TR	-37.7%	Pan-European High Yield	-19.9%
AlerianMidstreamEnergy	-50.8%	S&P 500 EqWg USD TR	-36.6%	US Corporate High Yield	-19.1%
S&P NoAmNatRes Sector TR	-48.4%	S&P 500 Pure Growth TR	-35.3%	HANG SENG INDEX	-17.5%
S&P 500 Pure Value TR	-46.2%	DAX INDEX	-35.2%	EM USD Aggregate	-14.4%
COLOMBIA COLCAP INDEX	-45.1%	DJBGlbInfCompT	-34.7%	Corporate	-12.9%
S&P MdCap 400 PureVa TR	-44.9%	Euro Stoxx 50 Pr	-34.1%	Credit	-9.9%
S&P SC 600 Pur Growth TR	-44.7%	S&P 500 Value TR	-34.0%	CSI 300 INDEX	-9.8%
S&P SC 600 Pure Val TR	-44.6%	S&P/TSX COMPOSITE INDEX	-33.9%	Generic 1st 'GC' Future	-7.6%
BRAZIL IBOVESPA INDEX	-42.4%	CAC 40 INDEX	-33.7%	Pan-Euro Aggregate	-4.4%
S&P MdCap 400 Value	-42.4%	S&P/ASX 200 INDEX	-32.6%	U.S. Universal	-3.7%
MSCI USA IMI EXT REAL ES	-42.3%	**S&P 500 INDEX**	**-31.9%**	Global Aggregate	-3.5%
S&P SC600 Value USD TR	-42.0%	S&P/CLX IPSA (CLP) TR	-31.9%	Government-Related	-3.5%
S&P SmCap 600 EW TR	-41.7%	**S&P 500 Total Return**	**-31.8%**	Euro-Aggregate	-3.3%
S&P MidCap 400 EW TR	-40.9%	FTSE 100 INDEX	-30.4%	U.S. Gov/Credit	-2.6%
MSCI US REIT INDEX	-40.7%	S&P 500 Growth TR	-30.0%	Asian-Pacific Aggregate	-2.2%
S&P US 600 SC TR	-40.4%	NASDAQ COMPOSITE INDEX	-29.9%	U.S. Aggregate	-1.9%
FTSE E/N Dev Net TRI USD	-40.3%	NYSE Arca Gold Miners TR	-29.7%	Treasuries	-1.3%
S&P MdCap 400 PureGw TR	-39.9%	NIKKEI 225	-29.3%	U.S. MBS	0.0%
S&P Mid Cap TR	-39.9%	S&P/BVLPeruGeneralTRPEN	-27.1%	U.S. Treasury	4.0%
FTSE EPRA/NAREIT Glb TR	-39.1%	S&PRealAssetsTR	-26.9%	S&P Strategic Futures TR	7.1%
S&P SC600 Growth USA TR	-39.0%	S&P/BMV IPC	-23.7%	S&P Dynamic Futures Official C	10.4%
S&P MERVAL TR ARS	-37.8%	Global High Yield	-20.4%		

Source: Graystone Consulting, Bloomberg. Past performance does not guarantee future results. Indices are unmanaged and not available for direct investment.

Given the widespread high volatility and drawdowns, many investors assume all the asset classes are correlated and there is no more diversification benefit. First of all, while correlations rose, they are still far from perfect, meaning there is diversification even when it feels like assets are all falling together. Second, is that even if assets are correlated, they can still reduce volatility from stocks alone if the mix includes assets with lower volatility. Of course that is separate from returns, but it reduces volatility nonetheless. Exhibit 3 shows, while the 30-day correlation rose between the S&P 500 and Bloomberg Barclays US Aggregate Bond Index, it is still -0.26, and slight below its average correlation of 0.02. On the alternatives side, while real assets correlation rose to 0.86 from its normally uncorrelated level, the managed futures index correlation actually fell from its average of -0.03 to -0.64. That’s impressive diversification “when you need it.”

Exhibit 3: Correlation between the S&P 500 and Other Assets



Source: Graystone Consulting, Bloomberg. Past performance does not guarantee future results. Indices are unmanaged and not available for direct investment.

So, the good news is the spike in volatility may be one sign we are nearing a bottom, and a recession generally is the beginning of the end of a bear market. So, now that our economists led by Ellen Zentner and team from Morgan Stanley & Co. have moved to a base case of global recession[2], and expect the US economy to contract at a 2.4% annualized rate in 1Q, followed by a historically sharp 30% contraction in 2Q20, perhaps we are closer to the rebound, especially if we see these other signs in addition to the volatility peak. According to Mike Wilson and team at Morgan Stanley & Co.[3], we're looking for the following: peak tightening of financial conditions (specifically peak funding/agency spreads, and peak USD), peak capitulation (especially in crowded trades), peak fears around the virus, trough long-term rates and inflation breakevens, and trough oil. Please see their recession playbook for ideas on where to invest, of course though sticking with diversification geared towards meeting your specific client needs.

Notes:

[2] Morgan Stanley Research, March 22, 2020, *A Deeper US Recession*

[3] Morgan Stanley Research, March 23, 2020, *Bear Markets End with the Cycle; Time to Employ a Recession Playbook.*

Important Information and Disclosures:

Information contained herein is based on data from multiple sources considered to be reliable and Morgan Stanley Smith Barney LLC ("Morgan Stanley") makes no representation as to the accuracy or completeness of data from sources outside of Morgan Stanley. This material has been prepared for informational purposes only. It does not provide individually tailored investment advice. It has been prepared without regard to the individual financial circumstances and objectives of persons who receive it. Morgan Stanley recommends that investors independently evaluate particular investments and strategies, and encourages investors to seek the advice of a Morgan Stanley Financial Advisor. The appropriateness of a particular investment or strategy will depend on an investor's individual circumstances and objectives.

This is not a "research report" as defined by NASD Conduct Rules 2241 and 2242. It was not prepared by the Research Departments of Morgan Stanley Smith Barney LLC or Morgan Stanley & Co. LLC or its affiliates.

The views and opinions expressed in this material are those of the author, **Jodie Gunzberg**, as of the date noted and do not necessarily represent those of Morgan Stanley Smith Barney LLC, its affiliates or its other employees. Of course, these views may change without notice in response to changing circumstances and market conditions. Furthermore, this material contains forward looking statements and there can be no guarantees that they will come to pass. The discussion of any securities in this material should not be construed as a solicitation to buy or sell such securities.

Past performance does not guarantee future results. The indices are unmanaged, and an investor cannot invest directly in an index. The indices are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns consist of income and capital appreciation (or depreciation) and do not take into account fees, taxes or other charges. Such fees and charges would reduce performance. Index performance is calculated on a total return basis and assumes that dividends and distributions were reinvested.

Tax laws are complex and subject to change. Morgan Stanley Smith Barney LLC ("Morgan Stanley"), its affiliates and Morgan Stanley Financial Advisors and Private Wealth Advisors do not provide tax or legal advice, are not "fiduciaries" (under ERISA, the Internal Revenue Code or otherwise) with respect to the services or activities described herein except as otherwise provided in writing by Morgan Stanley and/or as described at www.morganstanley.com/disclosures/dol. Individuals are encouraged to consult their tax or legal advisors (a) before establishing a retirement plan or account, and (b) regarding any potential tax, ERISA and related consequences of any investments made under such plan or account, and (c) to understand the tax and legal consequences of any actions, including implementation of any estate planning strategies, or investments described herein.

Asset allocation, diversification and rebalancing do not assure a profit or protect against loss. There may be a potential tax implication with a rebalancing strategy. Please consult your tax advisor before implementing such a strategy.

The investment management services of Morgan Stanley Smith Barney LLC and investment vehicles managed by Morgan Stanley Smith Barney LLC or its affiliates are not guaranteed and could result in the loss of value to your account. You should note that investing in financial instruments carries with it the possibility of losses and that a focus on above-market returns exposes the portfolio to above-average risk. Performance aspirations are not guaranteed and are subject to market conditions. High volatility investments may be subject to sudden and large falls in value, and there could be a large loss on realization which could be equal to the amount invested.

Alternative investments often are speculative and include a high degree of risk. Investors could lose all or a substantial amount of their investment. Alternative investments are suitable only for eligible, long-term investors who are willing to forgo liquidity and put capital at risk for an indefinite period of time. They may be highly illiquid and can engage in leverage and other speculative practices that may increase the volatility and risk of loss. Alternative Investments typically have higher fees than traditional investments. Investors should carefully review and consider potential risks before investing.

Bonds are subject to interest rate risk. When interest rates rise, bond prices fall; generally, the longer a bond's maturity, the more sensitive it is to this risk. Bonds may also be subject to call risk, which is the risk that the issuer will redeem the debt at its option, fully or partially, before the scheduled maturity date. The market value of debt instruments may fluctuate, and proceeds from sales prior to maturity may be more or less than the amount originally invested or the maturity value due to changes in market conditions or changes in the credit quality of the issuer.

Investing in **commodities** entails significant risks. The commodities markets may fluctuate widely based on a variety of factors including changes in supply and demand relationships; governmental programs and policies; national and international political and economic events; war and terrorist events; changes in interest and exchange rates; trading activities in commodities and related contracts; pestilence; weather; technological change; and, the price volatility of a commodity. In addition, the commodities markets are subject to temporary distortions or other disruptions due to various factors, including lack of liquidity, participation of speculators and government intervention.

Equity securities may fluctuate in response to news on companies, industries, market conditions and general economic environment. Companies paying dividends can reduce or stop payouts at any time.

Morgan Stanley Smith Barney LLC is a registered Broker/Dealer, Member SIPC, and not a bank. Where appropriate, Morgan Stanley Smith Barney LLC has entered into arrangements with banks and other third parties to assist in offering certain banking related products and services.

Investment, insurance and annuity products offered through Morgan Stanley Smith Barney LLC are: NOT FDIC INSURED | MAY LOSE VALUE | NOT BANK GUARANTEED | NOT A BANK DEPOSIT | NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY