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What's going on, what's the outlook?

Market turbulence in Q1 2020

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Introduction

Global markets continue to experience historic moves as a result of the COVID-19 outbreak. While we have seen market shocks before, each one is unique in origin and evolution. Many parallels are being cited to past shocks. While there are similarities, we believe the current stress has three major differences:

1. It began and remains a health crisis first and foremost, but the evolution to a pandemic is having global economic and market impacts on a scale not seen before.

2. The velocity, and the global coordination, of the shock is unprecedented. Major developed countries, and soon the world, have gone from stability and economic growth to recession in a matter of weeks. The initial expected impacts were reflected in markets in a matter of days. For context, global equities had a peak-to-trough in the aftermath of the global financial crisis (GFC) of almost 60% over the course of 18 months.[1]

3. We believe certain market dynamics leading up to this crisis compounded market moves and the speed of reaction. Namely, it came on the heels of one of the longest and strongest bull markets in history, fueled by government policy and the resulting excessive risk taking, much of it in the form of passive investment.

Developments are still unfolding, and the majority of investment managers are yet to confirm their performance for Q1 2020, but we offer some initial and general observations at this stage across the equity, fixed income and hedge fund landscape.

[1]The MSCI World (Total Return) Index fell 57.5% between October 31, 2007 and March 9, 2009. Source: Thomson Reuters Datastream

Equities

Equity markets have fallen materially with significant levels of volatility and some of the largest one-day moves in modern history (on March 12 the S&P 500 fell 9.5%, followed by a 9% recovery the following day and a 12.5% fall the day after). While the speed of the decline has been very swift, the size of the fall has not yet been as severe as in previous crises, and valuation levels (using price to book) are not yet as low. Equally, where most market crashes are characterized by reversal in market leadership, this time has been different, with the winners of previous years (large cap tech, growth and momentum) continuing to outperform while the laggards have remained the same (value and small caps).

Unlike in other asset classes, liquidity does not appear to be a significant issue for equities outside of the more illiquid smaller cap names. However, in common with previous crises, one of the biggest risks equity strategies face is the selling of assets to raise capital, creating pressure on some managers and strategies. It is too early to tell the extent to which this will materialize, but the longer the market crisis lasts, the higher the risks.

Asset managers continue to stress the long-duration nature of equity investments, and while there has been some repositioning of portfolios away from particularly stressed companies, activity appears to be relatively modest, reflecting a view that many companies are likely to recover and represent appealing value. A recovery will almost certainly materialize at some point, and there are likely to be some attractive opportunities for those investors able to capitalize.

The following table shows the quarter-to-date performance of a range of indices in the current crisis, along with the falls (peak to trough of the MSCI World Index), and recovery over the year that followed, in the two most recent market crashes (the GFC and dot-com bubble of 2000). The performance in green highlights those indices that outperformed the MSCI World Index in each period, and the red highlights those that underperformed.

Index	COVID-19	GFC		Dot-com	
	Q1 2020	Fall	Recovery	Fall	Recovery
MSCI World	-20.9%	-57.5%	75.3%	-48.8%	38.6%
MSCI Emerging Markets	-23.6%	-62.5%	108.3%	-44.9%	60.1%
MSCI USA	-19.6%	-54.5%	71.9%	-48.7%	36.7%
MSCI China	-10.2%	-64.8%	83.5%	-45.3%	59.5%
MSCI World Small Cap	-30.0%	-60.1%	101.9%	-27.3%	59.6%

Index	COVID-19	GFC		Dot-com	
	Q1 2020	Fall	Recovery	Fall	Recovery
MSCI World Value	-26.8%	-60.6%	83.3%	-39.8%	45.7%
MSCI World Quality	-15.2%	-48.0%	66.2%	-38.6%	23.3%
MSCI World Momentum	-14.4%	-55.5%	50.3%	-43.8%	20.7%
MSCI World Minimum Volatility	-15.4%	-47.7%	54.3%	-22.8%	27.8%
MSCI World ESG	-19.6%	-57.8%	79.3%		
MSCI World: Sector: Information Technology	-13.1%	-55.5%	82.3%	-81.8%	79.3%
MSCI World: Sector: Health Care	-11.3%	-37.2%	49.9%	-12.9%	14.6%
MSCI World: Sector: Financials	-31.7%	-76.3%	132.7%	-33.4%	50.7%
MSCI World: Sector: Energy	-44.6%	-48.0%	51.0%	-15.2%	22.2%

*Source: Thomson Reuters Datastream as at March 31, 2020. Performance is based on total return index value in USD. GFC/dot-com "fall" performance is peak to trough and recovery is the subsequent 12 months from the trough. *Price index used for return calculation due to data availability. Performance values are color-coded according to whether they outperformed or underperformed the MSCI World.*

The key points of note are:

- Small cap equities have sold off significantly – this is consistent with previous market crises.
- Large cap technology companies (in the US and Asia) have performed well; high quality businesses (those with high returns, low gearing and stable earnings) have also performed well.
- Value has significantly underperformed, largely due to a cyclical bias (including energy and financials) going into the crisis.
- Low volatility stocks have not provided as much protection as in previous crises; certain defensive industries have been specifically impacted by the nature of this crisis (for example airports, restaurants, brewers, insurance companies have all struggled), while some traditional

high volatility areas have benefited for the same reasons (for example biotech/healthcare, consumer discretionary and internet/technology companies).

- Momentum, which often performs poorly at an inflection point, has performed well in relative terms, as it went into the quarter with exposure to large cap IT and internet-related securities and a general growth bias.
- China has performed particularly strongly in relative terms (less negatively) and emerging markets more broadly have also held up reasonably well, highlighting the diversification benefits they bring;
- Sustainability, ESG and responsible investment strategies have generally performed well. Those with a low carbon focus have performed particularly strongly, and broad ESG indices have generally outperformed broad market indices. Managers with a broad sustainability and impact focus across environmental and social themes have outperformed their respective benchmarks, given the long-term growth and quality bias of many of these strategies. Unsurprisingly, their lack of exposure to fossil fuels, as well as luxury goods, airlines, and travel sectors has been a key driver, as well as a limited exposure to the financials sector.

Equity managers, like all managers, face a number of risks resulting from the current market crisis, with both short-term operational risks (for instance operational robustness, liquidity, counter party and model risk) and long-term business risks (for instance lower revenues, long-term performance, client outflows and regime change). However, the immediate impact on long-only equity strategies is perhaps less immediate. Equity managers have not reported any material liquidity issues to date.

If the crisis continues without resolution, equity managers will be impacted by lower market levels. We may also see outflows as asset owners look to raise capital from the most liquid strategies. Given the level of volatility, there are also likely to be some strategies that materially underperform their expectations.

Equity outlook

While we have no idea how long the health crisis will last, or what impact it will have on global economics, there will likely be a recovery in asset prices when there is some clarity over the path to a resolution. The unprecedented fiscal and monetary stimulus put in place by governments should support equity markets. As and when a recovery comes, it is likely that small cap equities and value stocks (particularly those with energy exposure) will perform well.

We continue to stress the long-term nature of equity investments and the opportunities that are like to materialize as some path to a resolution unfolds. Active management is likely to be a key tool in helping to navigate these volatile periods, while ensuring diversified exposure to multiple return drivers is key to ensuring portfolios are sufficiently robust for the short term.

Fixed income

Fixed income markets have been extremely volatile since the COVID-19 outbreak moved from a regional crisis to a global pandemic and we have seen marked changes in prices on a daily basis. In general, core government bonds have performed well, as central banks have eased monetary policy and implemented further forms of quantitative easing. However, riskier fixed income assets have not fared as well and we have seen a large scale repricing of assets, especially in corporate credit. Trading has also been challenging, with a marked widening in bid–to-offer spreads, and as financial intermediaries get used to their new working practices.

Fixed income managers are generally long risk against their respective benchmarks, with the vast majority overweighting spread sectors and/or moving down the rating spectrum. This has led to many active strategies underperforming.

Within money market or short-dated funds, the results are mixed. Strategies that are government focused are faring quite well, but forward-looking returns are obviously a lot lower, given the fall in yields. Strategies that invest in credit-related instruments have witnessed a lot of selling activity, which is affecting net asset values (NAVs). However, central banks are stepping in to offer support by increasing lending programs to stabilize markets.

Traditional bond indices have had mixed performance, but have generally performed quite well. The exception are global unhedged products that have suffered from the strong US dollar.

Initial reports suggest that most core managers have significantly underperformed their indices. However, core plus products have performed a lot worse, with some strategies underperforming their benchmarks by up to 7%. It is still too early to say, but when this quarter ends, we may see an erosion of all of the active management gains that many managers have achieved over the last 3-5 years.

In every region, credit markets have suffered the most, with sub-investment grade debt falling by around 20% in March.[2] Active manager performance has been more mixed, with some having built a more defensive position going into late February, due to their thoughts on the credit cycle. However, given the current volatility, lack of liquidity and widening bid-to-offer spreads, there has been a huge dispersion in manager performance over this period, with most managers underperforming their respective indices. Securitized, or structured credit products have also not been immune from credit widening, although there are marked differences depending on what sectors and what part of the capital structure they are focused on.

[2] Source: Thomson Reuters Datastream. As at March 23, 2020, the Bloomberg Barclays Global High Yield Index was down by 21.5% from its 2020 peak as measured in US dollars. As at March 31, 2020, the index was 15.8% off its peak having rallied towards the end of the quarter.

In emerging market debt (EMD), markets reached a low of 20% in March[3], but prices are experiencing wild swings on a daily basis. Although going into the crisis many managers were defensively positioned, they have not been rewarded in terms of positive alpha. Given the composition of EMD indices includes varying degrees of energy-related sovereigns or companies, an overweight to any of these issuers would also have had a negative impact on relative performance. The strong US dollar has also meant marked underperformance in emerging market currencies, especially oil producing nations.

Sub-investment grade debt has been the hardest hit of all sectors, with US high yield spreads widening from 400bps at the start of the crisis to around 1,000bps [4]at the end of the quarter. Leveraged or bank loan assets have also sold off by a similar amount, with indices reaching a low of approximately -20% from their 2020 peak.[5] With energy companies being the hardest hit, US issuers have been impacted more than European high yield issuers. Alpha has also been mixed in this sector, but we have noticed that many managers have been active in buying those companies that have moved into distressed territory, but are still, in their opinion, "money good".

Benchmark-agnostic strategies have also had a difficult time with all strategies underperforming cash, as we would have expected. Unconstrained funds are down anywhere between 5% and 15% up to March 24, as these strategies will generally allocate a large percentage of their portfolio to riskier assets.[6] Given multi-asset credit funds are designed to be long sub-investment grade debt, they have obviously had a torrid time. Most managers in this sector were defensively positioned and this has led to some strong relative performance against a blended 50% high yield and 50% bank loan index. Absolute return fixed income products have been the most challenged versus our expectations. Some managers have performed relatively well, producing numbers that are flat or in line with cash, whilst others that are more credit heavy have witnessed drawdowns of around 8%. Given the diversity and risk parameters of these products there are obviously outlying strategies that have performed worse than the numbers quoted.

Most of the data above was collated as at March 24, and given the existing volatility it is hard to ascertain that these are still correct at the time of writing. However, in general, we believe most fixed

[3] Source: Thomson Reuters Datastream. As at March 19, 2020, the JP Morgan EMBI Global Composite was down 20.0% from its 2020 peak as measured in USD. As at March 31, 2020, the index was 14.5% off its peak having rallied towards the end of the quarter.

[4] Source Thomson Reuters Datastream. As at March 31, 2020, the option-adjusted spread on the Bloomberg Barclays Global High Yield Index was 10.08%.

[5] Source: Thomson Reuters Datastream. As at March 23, 2020, the S&P Leveraged Loan Index was down 20.7% from its 2020 peak as measured in US dollars. As at March 31, 2020, the index was 13.8% off its peak having rallied towards the end of the quarter.

[6] This performance estimate is *on* discussions with a sample of investment managers who provided estimated performance to Mercer towards the end of the first quarter.

income indices are in negative territory and the majority of active managers have underperformed their respective indices. Liquidity has also been challenging and this has been exacerbated by large redemptions in mutual funds and exchange-traded funds (ETFs), causing certain ETFs to trade at discounts of over 5% to their respective indices.

Fixed income outlook

These are troubling times and we expect the current volatile environment will remain with us for at least a few months. However, given the rapid and extreme widening of credit spreads, we have become more optimistic on credit sectors in general, especially sub-investment grade debt. Over the latter half of last year, we highlighted our opinion that we were nearing the end of this extended credit cycle. Our global dynamic asset allocation committee was positioned long cash instruments and short corporate credit. In the last few days, we have reversed these positions and are now long spread assets.

Hedge funds

During the initial stages of the COVID-19 outbreak, hedge funds generally performed well, as markets behaved in an orderly fashion and risk was priced in a relatively logical and direct way. Companies and industries that clearly carried a risk associated with the economic impacts of COVID-19 sold-off relative to those that appeared to be less impacted. As the global spread of COVID-19 accelerated, markets succumbed to fear and panic at unprecedented speeds, leaving few places to hide.

A well-constructed hedge fund portfolio serves to dampen downside through risk exposure diversification. Collectively however, they are most effective in this role during orderly, fundamentally-based and sustained drawdowns. Hedge funds are generally less effective in achieving this objective during a coordinated global economic shock when returns across asset classes are highly correlated. Even less so when these dynamics occur over days or hours, as has been the case in March.

Given the reduction of proprietary trading and dealer desks since the GFC, we have seen hedge fund managers contribute and provide input to regulators and governments to help ensure orderly market functions. We expect the role of hedge funds as liquidity providers to be more evident from here. A nimble, opportunistic and unconstrained approach has allowed quality teams and strategies to pivot and respond effectively to the rapid changes in markets.

Long/short equity strategies

Performance of long/short equity managers has been largely dependent on managers' exposures heading into March, and their initial risk management responses. Net long equity market exposure of any magnitude was generally punished as events unfolded, with additional headwinds in certain sectors, such as retail, travel, and leisure. The majority of managers responded by reducing their net exposures, focusing on higher quality positions initially to limit losses while also monetizing and rotating shorts and hedges. Our initial estimates suggest performance on average is likely to be in the range of less than half the drawdown of global equities for directional long/short strategies and better than that for equity market neutral strategies. However, we expect meaningful dispersion with outliers on both sides of this range. On balance, we are generally pleased with how most managers in long/short equity have navigated the period and believe our preference for diversification and generalists has largely been rewarded.

In terms of opportunities, it may still be too early to tell, but our initial assessment suggests these events could potentially accelerate some of the secular drivers already underway in areas such as online retail, payments, cloud computing, automation, and streaming media. Healthcare and particularly pharmaceuticals, therapies, and devices are likely to benefit for some time as global initiatives look to learn and be better prepared for similar healthcare shocks. Long/short equity managers are uniquely positioned to take advantages of the winners and losers of cyclical and secular changes over time.

Event-driven strategies

Initial effects across our event-driven universe (special situations, long/short credit, and distressed) are largely dependent on directionality (exposure to broad market movements) and relative exposure to equity or credit. More equity-oriented strategies across soft and hard catalyst opportunities, or those that might have a higher beta orientation including activist strategies, generally have fared worse to this point.

Merger arbitrage spreads widened dramatically in a number of current deals and the impacts across managers were a function of hedge ratios and leverage (those less hedged or more leveraged performing worse). Credit opportunities, and particularly existing distressed debt and liquidation plays, were less impacted and have held up well on a relative basis through a combination of less frequent valuations and less dependence on market sentiment.

Discussions with managers suggest there was significant stress across credit markets, particularly beginning the week of March 16. Looking ahead, we believe the opportunity set has improved, near-term, in areas such as mergers and convertible arbitrage. Longer-term opportunities in stressed and distressed debt are likely to reward investors well over the next 3-5 years, depending on the duration of and depth of the economic slowdown.

Global macro strategies

Discretionary and systematic macro approaches have generally proven their ability to bring the diversification and low correlation we seek from the exposure. Global developed market exposure proved more favorable than emerging market exposure due to liquidity and policy fallout. A general flight to quality and increases in volatility created a range of dislocations in fixed income, currencies and commodities that agile discretionary managers were able to generate returns from. Systematic strategies particularly across short-term trends proved to be a bright spot, for the most part, as models and systems responded to the changing directionality and volatilities quickly.

Diversified alternative risk premia performance has been mixed so far, but generally negative on balance, with challenges across value and carry primarily. Early indications suggest meaningful dispersion across global macro strategies, but on average, most discretionary and systematic strategies have done well on a relative basis to date. We believe global macro-oriented managers have been, and continue to be, well suited to navigate the pace of change and resetting of global economic conditions.

Relative value strategies

Many relative value strategies struggle during market shocks, as historical correlations and relationships break, both within and across asset classes, causing spread trades to widen sharply. Additionally, these strategies have a greater dependency on leverage to achieve attractive returns, which can magnify results during extreme market moves by increasing financing pressures. On balance, relative value strategies were a detractor, led by the largest exposures in fixed income followed by cross-asset trades. However, firms have learned lessons from 2008 and have worked to ensure capital and financing stability to enable them to sustain positions, as spreads eventually converge. As was the case following the GFC crisis, the period after the initial stress is likely to provide a highly dislocated and compelling opportunity for managers able to weather the interim market challenges.

Hedge funds outlook

We believe unconstrained hedge funds possess a broader toolset, which allows for robust risk management and nimble portfolio construction and is likely to be rewarded during times of uncertainty and heightened volatility,. On average, the initial response by hedge funds has been to manage risk, limit losses, and reassess. We expect managers will be looking ahead at opportunities as a result of meaningful dislocations now and to come. We see near-term opportunities for event-driven strategies, such as merger and convertible arbitrage, and global macro. Recent events may improve the prospects for fundamental stock-pickers managing long/short equity strategies that are uniquely positioned to take advantages of the winners and losers of cyclical and secular changes over time. Longer-term, we believe there is likely to be a multi-year opportunity in stressed and distressed credit as restructurings, workouts, and liquidations seem inevitable.

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