OIL-PRICE SHOCK ADDS TO CORONA WORRIES

The war for market share among oil producers has further tested investors' nerves, which we urge not to lose in these markets.

IN A NUTSHELL

_ While new infections of the novel coronavirus in China and South Korea have declined noticeably, the sharp increase in Italy has led to drastic measures by state authorities.
_ At the same time, the situation in the oil market came to a head, with Russia and Saudi Arabia engaging in an open battle for market share. U.S. shale-oil producers in particular are likely to suffer the most in the short term.
_ Concerns about a recession in Europe and distortions in the U.S. bond market led to a market selloff. Markets are likely to remain fragile, calling for caution, but not panic.

Financial markets fell dramatically on Monday, January 9, in many different asset classes. The main trigger was the collapse of the oil price by about 30% after Russia and Saudi Arabia entered into an open price war. The short-term impact is likely to be most severe for U.S. shale-oil producers. Although the situation surrounding the coronavirus also continued to deteriorate in Europe over the weekend, with even harsher quarantine measures and a growing number of event cancellations, this is unlikely to have been the main reason for the renewed market weakness. Not least because the declining new infection figures in China and especially South Korea - viewed in isolation - give cause for hope about the further spread of the coronavirus outside of Asia.

However, the oil-price shock has been affecting the financial markets via several channels. First, it is leading directly to a drastic fall in inflation rates and inflation expectations, which in turn is also directly reflected in government-bond yields: the 10-year U.S. Treasury yield fell to just over 0.3%, while German government bonds are trading at -0.85%. However, the real component of the yield also collapsed, which can be interpreted as increased growth skepticism among investors. The significance of the yields may have been somewhat diminished in view of large portfolio shifts towards supposed safe havens. In the short term, we believe the greatest burden from the oil -price collapse is likely to be felt in the markets for corporate bonds. The high-yield segment in the United States contains 10-15% companies from the energy sector, depending on the definition. Shale-oil producers need an average price of 40-50 U.S. dollars per barrel to operate profitably. There is correspondingly great concern about bankruptcies in this sector, even though many producers are likely to have hedged themselves on the futures markets for the next three to six months. Yields in the U.S. energy sector have increased substantially in the past weeks. The (option-adjusted) spread to U.S. Treasuries of the Bloomberg Barclays High Yield Energy USD has jumped from 700 basis points at the start of the year to now 1143 basis points.

In our opinion, the situation on the oil market could still come to a head before it eases. We suspect that Russia and Saudi Arabia may not be interested in a de-escalation for the time being. A more likely scenario is both of them doing everything in their power to boost production and sales in the short term before they make another attempt at coordinating their supply behavior. We therefore expect West Texas Intermediate (WTI) oil to fall to prices below 30 dollars per barrel, similar to 2016.

Overall, the oil price has only had a slightly negative effect on global economic growth. Nevertheless, the prospects for growth have worsened considerably in recent weeks. In Europe in particular, we expect economic output to decline the first half of the year, not least because of the far-reaching restrictions on movement in the north of Italy, the country's industrial heartland. In our base scenario, however, we continue to assume that the virus will also have passed its peak of spread in Europe in the second quarter. In addition, a low oil price has the effect of a small stimulus package for net import regions such as Europe or parts of Asia.

This should not prevent governments and central banks from adopting further aid measures. In Italy, aid packages amounting to 0.4% of gross national product (GNP) have now been passed, the grand coalition in Germany agreed on an aid package in the night to Monday. The United Kingdom is likely to follow soon, starting, probably in the budget to be delivered on March 11. In Asia, more extensive packages, including direct cash contributions to private households, have already been passed.

Central banks have also already taken many steps. So far, the U.S. Federal Reserve (Fed) has lowered key interest rates by 50 basis points. The market is pricing in further rate cuts at the next regular meeting on March 18. It cannot be ruled out that the Fed will again take extraordinary action and that it may resume bond purchases. The European Central Bank (ECB) has so far remained relatively cautious. We expect Thursday's meeting to result in liquidity measures, a temporary increase in bond purchases and probably also a reduction in the deposit rate from its current level of -0.5%, even though we do not expect this to provide much real economic support. In our opinion, the markets should primarily be interested in the extent to which the ECB can avoid possible liquidity bottlenecks for companies.

After the sharp falls of Monday, many stock markets, including the European ones, are now in bear-market territory, having corrected by more than 20% since their peaks. The U.S. markets are also close to this threshold. For the Dax, the daily loss of nearly 8% means the sixth highest loss in the past 40 years. The volatility of the Euro Stoxx and the S&P 500 has meanwhile exceeded 60, a level not seen since the financial crisis.

OUTLOOK

We believe the coming days are likely to remain very volatile. A key short-term risk is likely to be a self-reinforcing process of price falls coupled with high volatility, which in the case of many institutional funds will require further portfolio adjustments, especially the sale of investments such as equities or corporate bonds. As the latter markets in particular are, in some cases, struggling with very limited liquidity, further distortions could emanate from here. The development of corporate earnings or valuation ratios is currently fading into the background. In our view, a sustained recovery will only set in either after a major, coordinated fiscal or monetary international rescue package. Or simply if, over time, a slowdown in the number of new infections in Europe and the United States becomes clearly apparent.

Ever since the last financial crisis (certainly in the crisis), it has frequently been the case that selling assets such as equities or corporate bonds on days like these, with similar high volatility, in retrospect turned out to not necessarily the best decision. And, even in crash scenarios dating further back, it has historically rarely been advisable to join in indiscriminate panic selling of the sort arguably observed on what has already been dubbed Black Monday. Instead, we believe the key is, to start with an assessment of the underlying future economic scenarios, whether talking about a company, country or sector. Only then can one analyze in which segments the market turmoil has created selling signals, or indeed buying opportunities. That said, ensuring sufficient liquidity in a portfolio in order to remain able to act in the coming days seems a good thing. Despite all the adversities and headlines that the coronavirus is currently causing, we feel that one should not lose sight of the usual course and plausible seasonality of such an epidemic. The encouraging figures of decreasing new infections from China and South Korea support this view, despite all the surprise potential that this virus still offers. What would cloud our cautiously optimistic view of the capital markets, however, would be three scenarios:

1. The global spread of the virus would cause it to flare up again in those regions, especially Asia, where it is already considered to be contained.
2. The United States proves to be insufficiently prepared and capable of acting in the face of a widespread epidemic.
3. The short-term effects of the virus uncover the structural weaknesses that have built up in some states and companies in recent years.

We would act cautiously before there is more clarity on these points.

GLOSSARY

One basis point equals 1/100 of a percentage point.

Technically, a bear market refers to a situation where the index's value falls at least 20% from a recent high.

Black Monday refers to the stock market crash on October 19, 1987.

The Bloomberg Barclays High Yield Energy USD Index measures the option-adjusted spread to U.S. Treasuries of high-yield U.S. energy companies

A central bank manages a state's currency, money supply and interest rates.

The Dax is a blue-chip stock-market index consisting of the 30 major German companies trading on the Frankfurt Stock Exchange.

The Euro Stoxx is a broad-based equity index comprising 301 constituents from the Eurozone.

The European Central Bank (ECB) is the central bank for the Eurozone.

The financial crisis refers to the period of market turmoil that started in 2007 and worsened sharply in 2008 with the collapse of Lehman Brothers.

A futures contract is a standardized, contractual agreement to trade a financial instrument or commodity at a pre-determined price in the future.

Gross national product (GNP) is economic statistic that measures what a country's citizens produced. It includes gross domestic product (GDP) plus any income earned by residents from overseas investments, but excludes income earned within the domestic economy by overseas residents.

A hedge is an investment to reduce the risk of adverse price movements in an asset.

High-yield bonds are issued by below-investment-grade-rated issuers and usually offer a relatively high yield.

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

The option-adjusted spread ("OAS") is a commonly used measure for fixed-income securities with embedded options (call, put or sink). It makes the yield of such instruments comparable to similar securities without such embedded options. Typically, the OAS for credit sensitive instruments is quoted vis-à-vis the respective Swap spread curve. Technically, option pricing methods are used to evaluate the instruments with embedded options.

In economics, a real value is adjusted for inflation.

The S&P 500 is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

A safe-haven investment is an investment that is expected to retain or even increase its value in times of market turbulence.

Shale oil is a type of unconventional oil found in shale formations.

Treasuries are fixed-interest U.S. government debt securities with different maturities: Treasury bills (1 year maximum), Treasury notes (2 to 10 years), Treasury bonds (20 to 30 years) and Treasury Inflation Protected Securities (TIPS) (5, 10 and 30 years).

The U.S. Federal Reserve, often referred to as "the Fed", is the central bank of the United States.

Valuation attempts to quantify the attractiveness of an asset, for example through looking at a firm's stock price in relation to its earnings.

Volatility is the degree of variation of a trading-price series over time. It can be used as a measure of an asset's risk.

West Texas Intermediate (WTI) is a grade of crude oil used as a benchmark in oil pricing.

APPENDIX: PERFORMANCE OVER THE PAST 5 YEARS (12-MONTH PERIODS)

	02/15 - 02/16	02/16 - 02/17	02/17 - 02/18	02/18 - 02/19	02/19 - 02/20
Dax	-16.7%	24.6%	5.1%	-7.4%	3.3%

Past performance is not indicative of future returns.
Sources: Bloomberg Finance L.P., DWS Investment GmbH as of 3/9/20

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