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TRANSCRIPT

Looking for Lessons from the Past

Featuring: ***Dimitris Melas***, MSCI's Global Head of Core Research

Adam: This is MSCI Perspectives, your source for weekly research insights as investors respond to the COVID-19 pandemic. I'm your host Adam Bass and today is March 27th 2020. This week, we spoke with Dimitris Melas, MSCI's Global Head of Core Research. Dimitris, you're calling in from St Albans, is that right?

Dimitris: That's right Adam. This is a small town that's very famous in England for having the oldest pub in England. This pub has lasted for 1200 years, but actually faces extinction now because of the crisis and because of the shutdown of all public venues that the UK government has implemented.

Adam: I hope you get to raise a pint there again soon. So let's broaden the view a little bit. What's going on in the markets?

Dimitris: What we've seen is that volatility jumped quite abruptly in late February and in early March, in fact, only as recently as mid-February, equity market volatility was pretty low, up around 10% and it's now, equity markets globally, equity market volatility is currently around 70% based on the MSCI global trading model. It was mentioned that according to our global trading model, equity market volatility peak at 60% during the global financial crisis.

Adam: That's incredible, is the market panicking?

Dimitris: My observation so far has been that markets have reacted quite rationally to this extreme and, you know, economic shock that we're facing.

Adam: This is rational behavior from the market?

Dimitris: When you have an economic shock of this magnitude, obviously economic activity slows down, you know, the dropdown that we've seen so far in global equities which is about 25% or 30% depending on where you measure it from. Given the circumstances that we're going through and the crisis we're facing, it's actually quite rational market reaction I don't think there's been evidence of any panic.

Adam: And what were we looking at in terms of drawdowns during the global financial crisis?

Dimitris: Well, back then the drawdown was in excess of 50%

Adam: Have there been any areas of the market that have been resilient or at least more resilient than others?

Dimitris: We have seen a number of areas in the market, defensive assets that have actually outperformed. Selling has not been in the screen yet and we've seen that both across asset classes as well as within asset classes. For instance, we've seen that cash and bonds have generally outperformed equities. Now, if we look at the fixed income asset class, again we've seen the evidence of fly to safety, government bonds have outperformed corporate bonds. The yield on the 10 year US Treasury note has actually dropped by about 100 basis points in the last month or so, while the spread of corporate bonds over government bonds in the US has risen about 100 to 125 basis points over the same period. If you look at currency markets, volatility has shot up, but the US Dollar and the Swiss Franc which are typically considered to be safe havens in currency markets have outperformed and have rallied relative to other major currencies. So it's interesting to see what's been happening within equities. And again, we see clear evidence of, you know fly to safety. If you look at sectors around the world, communication services, healthcare, utilities, some of the defensive sectors that are less sensitive to the economic environment have outperformed. And finally when you look at style, style factors, size, quality, low volatility and interestingly sustainability have all outperformed.

Adam: Interesting, so you're saying ESG has been performing like a defensive factor?

Dimitris: Absolutely right. And you know, Adam what's interesting here, what's interesting about this crisis is that it provides a live severe stress test for some investment strategies and investment vehicles that are relatively recent and have gained a lot of acceptance in the market over the last 10 or 12 years since the drop of the financial crisis. If we register back, if you think about some of the major transformations in the investment process over the last 10 or 12 years, we can certainly identify three major structural changes. Greater acceptance in use of index investing and index strategies, greater use and rising allocations to factor investment and factor strategies and finally, ESG, sustainability over the last 10 to 12 years has increasingly gained more traction, more acceptance as investors around the world. So you know, the current very extreme market environment provides a stress test for these strategies that have gained a lot more traction and acceptance in the market over the last 10 to 12 years and in fact we're seeing that so far, index investment strategies in general have performed as expected. We also see that factor strategies have performed in line with expectations. For example, low volatility strategies have defensive characteristics based on historical performance, but now we're seeing very much during the crisis global activity has provided so far relative downside protection. In other words, it has enabled investors to weather the storm slightly better with lower losses so far.

Adam: Every time is different obviously, but we have had crisis before. How does this one compare? How did the market evolve during previous crisis?

Dimitris: The market turmoil that was sparked by the Corona Virus pandemic is really reminiscent of market conditions after the terror attacks in 2001 and also during the onset of the global financial crisis in 2008. What happened in the previous extreme events that I mentioned is that, actually the equity market continued to decline for a period of 6 to 12 months after the onset of the initial shock. Volatility continued to rise.

Adam: And what were the signs of recovery?

Dimitris: What you will find is that some of those sectors and strategies that were hit quite badly during the crisis are actually the ones that tend to down-start more sharply when the recovery starts to happen. So, for example, small cap securities and value strategies are very, very badly hit during the current crisis and that was the case also in previous extreme market conditions, and actually in 2003 when markets started to recover, and also in 2009. It was those strategies that started to perform well. So look, typically investors look at two or three different areas for signs of stability and recovery, for signals that the environment is improving and we may be coming out of the crisis. One of those areas is policy response both in this case, both physical and monetary policies response has been unprecedented in terms of scale but also in terms of speed. We have seen the Fed and other central banks slashing interest rates and they've also injected huge amounts of liquidity into the global economy by purchasing fixed income securities and also by taking other quantitative using measures.

Physical authorities around the world have also announced a number of measures, tax cuts, others public spending measures designed to show up, to support the economy. So in addition to policy response, investors are looking at market volatility and in the previous market crisis, what we saw is volatility peaked and started to decline a few months before the markets started to recover. Finally the other indicator that they often investors focus on during periods of extreme market conditions is valuations. Valuations or financial assets or equity markets in particular, you know, if we look at previous crisis they declined substantially and started to look attractive before the markets started to recover. And I think we can look to market action and market performance in Asia perhaps for indications of how markets may evolve in the rest of the world as we hopefully start to come out of this crisis soon.

Adam: Before you go Dimitris, I have to ask, what was that name of that pub you mentioned?

Dimitris: The Old Fighting Cox.

Adam: And once this is all behind us and assuming they're still open, will you be heading down to the Old Fighting Cox?

Dimitris: Without a doubt!

Adam: That's all for this week. Thanks to Dimitris and to all of you for joining us. Be sure to follow us on the MSCI LinkedIn page and to bookmark www.msci.com/coronavirus for all our crisis related content. Stay safe everyone.

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