THE WALL STREET JOURNAL.

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MARKETS

The Worst of the Global Selloff Isn't Here Yet, Banks and Investors Warn

Wall Street is only now coming to grips with the dislocation being wrought by the coronavirus

Stocks' declines look modest compared with some prior downturns.

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By Anna Hirtenstein and Akane Otani

March 22, 2020 7:36 am ET

The most brutal stretch for global markets since the financial crisis likely isn't over yet, say investors and analysts who believe it is too early to assess the possible scale of economic damage from the coronavirus.

In just a few weeks, U.S. stocks have lost roughly a third of their value. In recent weeks, investors have even fled assets like U.S. government bonds and gold that typically do well during times of turmoil, underscoring the extent of the panic and the shock to once-robust investor sentiment delivered by the global health emergency.

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But many analysts and portfolio managers warn that neither those declines nor recent extraordinary actions by the Federal Reserve are likely to signal the end of the market crunch. They note that by historical standards, stocks' declines look modest compared with some prior downturns, given the early indications of how much damage virus-related shutdowns are likely to do to global growth. The S&P 500 is down 32% from its February peak. In comparison, stocks tumbled 57% during the financial crisis and 49% after the dot-com bubble burst in 2000 before beginning to rebound.

What's more, some investors say, Wall Street is only now coming to grips with the dislocation being wrought by the virus. Analysts at Goldman Sachs Group Inc. said this past week they expect U.S. economic output to tumble 24% in the second quarter, one of the worst readings on record and potentially foretelling a U.S. recession even if growth picks back up in the second half of the year.

With everyday life grinding to a halt from New York to Milan, the world's biggest money managers and banks say they believe one of the most prominent market casualties from this episode could be long-term investors' ingrained inclination to step in to buy the dip. Before the coronavirus outbreak, investors' faith in the strength of the U.S. economy had led them repeatedly to rush back into the market after pullbacks to scoop up discounted shares, a response that became so routine it came to be known by its own initials, BTD or, with more intensity, BTFD. Now, many believe it could be some time before that behavior returns.

"The ultimate impact of the virus on economies and markets is highly speculative at this time since there is so much we do not know about how the outbreak will actually evolve from here,'' said Rick Lacaille, global chief investment officer of State Street Global Advisors. "We need clarity on many fronts."

Investors will get more of a sense of how badly the economy has been hit in the coming days when data on the manufacturing and services sectors and jobless claims are released.

The latter data point has already spiked—leading Goldman to predict there could be an "unprecedented surge" in the number of Americans applying for unemployment benefits over the next week.

The firm forecasts the S&P 500 could be in for a 41% fall from peak to trough. Bank of America Corp. believes the selloff might not ease until the S&P 500 hits 1800—a 47% drop from its February record. And Credit Suisse Group AG , which notes stocks didn't hit their trough during the SARS pandemic in 2003 until a week after the number of new infections peaked, estimates the S&P 500 could be in for a 35% drop overall.

If economic output shrinks by double-digit percentages in the second quarter, it would be a devastating pullback even by historical standards: Adjusted for inflation and seasonality, GDP fell less than 5 percentage points from peak to trough during the 2007-09 recession, which was the longest downturn since World War II.

To put a floor on the current market rout, some of the world's biggest investors say they need three things: better information on the scale of the coronavirus pandemic, powerful support from governments and more forceful intervention in markets.

A key issue is the uncertainty surrounding what it will take to halt the fast-moving health crisis, and the economic fallout of such measures, investors say. Governments are using a range of strategies, from stringent lockdowns in Italy, France and Spain to looser recommendations of social distancing in the U.K. and much of the U.S. As the measures vary, so does the level of economic disruption.

Investors need "clarity on the ultimate scale of the problem and evidence that the infection's curves are bending globally," said Jean Boivin, head of BlackRock Investment Institute. Credible news on development of a vaccine and treatments would also help restore confidence, he said.

Central banks in some of the world's biggest economies have taken steps to cut interest rates to bolster economic growth and are acting together to boost the dollar's availability. Investors are looking for governments to also coordinate actions.

"One thing we've learned in the crisis in 2008 is that policy is a lot more than the sum of its parts if it's done as a global response," said Mr. Boivin.

So far, governments don't seem to have deployed enough fiscal stimulus—especially in Europe, said Didier Borowski, head of macroeconomic research at Amundi. The relief and stimulus measures should probably be equivalent to 2% to 3% of the eurozone's economic output, he said.

But others believe fiscal stimulus won't do much to arrest the market selloff.

Cornerstone Macro analyzed the stock market's response to bursts of fiscal stimulus during the 2001 and 2008 downturns and found the S&P 500 actually continued falling over a one-year period.

"Selloffs end when the problem that caused the selloff is under control," said Michael Kantrowitz, chief investment strategist at the firm.

Another area of concern for investors: the fact that credit markets, encompassing both the safest sovereign bonds as well as more speculative corporate debt, have been in turmoil due to liquidity constraints, the pressure to unwind the riskiest trades and investors' demand for cash.

Investors would like to see "more aggressive steps by policy makers to provide some stability in fixed-income markets,'' said Evan Brown, head of multiasset strategy at UBS Asset Management. "This includes a Fed/Treasury partnership to provide lending against corporate bonds as collateral and the ECB aggressively stepping up purchases of Italian debt."

The Fed said earlier this month that it would provide $1.5 trillion through short-term lending and spend $500 billion on Treasury securities to improve market functioning. On Wednesday, the Treasury Department approved a new lending facility from the Fed to act as a backstop for money-market mutual funds. While this move is welcomed, investors say that the market is still weighing its effectiveness.

"Market participants need to feel they are backstopped without question,'' said State Street's Mr. Lacaille. "Arguably this is what the Fed and Treasury Department have tried to signal and achieve, turning from messaging into action, but it seems there is a leap of faith needed by the market too.''

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