As pandemic unfolds, fear and finance collide

March 23 2020, by Emily Litvack

Credit: Eddie Canto/Research, Innovation & Impact

Despite global efforts to stall the spread of the novel coronavirus, growing fears surrounding the pandemic have caused markets to respond with record-breaking volatility. On Monday, the nation's volatility index, often referred to as a "fear index," closed at the highest value in its 30-year history as the S&P 500 fell more than 7% within seconds of opening, triggering an automatic 15-minute stop in trading. Once trading resumed, the market posted its largest one-day point drop in history.

Scott Cederburg, a chartered financial analyst and associate professor of finance in the Eller College of Management—who previously served as a senior financial analyst with Ethanol Capital Management and an investment analyst with Schwendiman Funds—talked about the economic impacts of COVID-19 and the role that unce,rtainty plays in markets.

Q: The stock market is quite volatile right now. Why?

A: The stock market crash likely reflects both a change in expectations and uncertainty about what else to expect. Many companies will take big hits on earnings from this pandemic. In some industries, a small drop in revenue could swing a company from a large profit to a large loss.

Some of the stock market's reaction probably reflects an expectation that corporate earnings will be low for the next couple of quarters—and maybe beyond. Uncertainty also plays a big role. There are several unknowns about the pandemic and how it will affect the economy. We have seen many investors sell stocks and buy U.S. Treasury bonds in a "flight to quality," which probably reflects that uncertainty. We went from record-high stock prices to record-high Treasury bond prices in less than a month.

The VIX, or the volatility index, is often referred to as a "fear index." On Monday, the VIX closed near 83. For reference, the highest VIX value during the financial crisis in 2008 was about 81. Monday marked the highest close in the 30-year history of the VIX.

Q: The Federal Reserve dropped the federal interest rate to 0% this week. What effect did they hope it

would have?

A: The idea behind lowering the interest rate is to make money available to banks, lenders, and other financial institutions at a near-zero interest rate. Hopefully these institutions are, in turn, willing to lend money to small and large businesses that suddenly need funding due to the effects of the virus and the response. Many businesses will need financing to overcome sharp drops in revenue as travel, access to restaurants and bars, and other activities are restricted.

Reportedly, the Fed cut rates on Sunday because of a potential "credit crunch" on Monday. There is a $1 trillion market of short-term borrowing by corporations, and this market seems to be drying up as investors are uncertain about the pandemic's effect on borrowers' ability to pay. The Fed is attempting to introduce more money into the credit market to loosen conditions.

Lowering the interest rate because of the pandemic seems different from the Fed's typical response of lowering rates as the economy slows. In typical recessions, lower interest rates may help businesses borrow to invest in longer-term projects like building a new production line or opening a new store. In this pandemic, it seems that the lower interest rate was meant to help open up shorter-term borrowing by businesses that need to cover operating costs over the coming weeks and months.

Q: Is it working as intended?

A: It's a little tough to say. It's still early and we don't know what the markets would have looked like without the cut, but the credit market still seemed fairly stressed on Monday. It seemed possible that more targeted action was needed, and the Fed announced on Tuesday additional measures to support the short-term corporate borrowing market.

Scott Cederburg. Credit: University of Arizona

Q: How is supply and demand affected by the pandemic?

A: The decreased demand for travel and entertainment, including air tickets, hotel rooms, restaurants and tickets to movies and games, is especially noticeable. From the producer's side, generally speaking, the supply of many goods could suffer from supply chain interruptions, lost worker productivity and other effects of restrictions.

Another important market in recent days has been the global oil market. Oil prices had already been dropping prior to the pandemic due to a decrease in global demand. Much of that was attributable to a decrease in Chinese demand during their outbreak. Recently, disagreements within the Organization of the Petroleum Exporting Countries have caused even more oil to flood into the market and make prices drop further. Most United States oil producers have relatively high production costs, so the drop in oil prices has significantly hurt that industry.

Q: What's one of the industries hardest hit by the pandemic?

A: The airlines are one of the most affected industries. Travel restrictions and voluntary travel cancellations are having a big impact on their revenue. These businesses naturally have large costs, such as plane leases and employee salaries, that they incur regardless of whether flights are operating normally. Even a small decrease in ticket sales can threaten the survival of airlines. The government seems to be heading toward an aid package for the industry to keep the companies afloat until this temporary shock ends.

Q: Some people have called for direct financial support to individuals and families rather than to banks and large corporations. Which approach would you advise?

A: Both families and corporations may need financial support to get through the pandemic and stabilize the economy.

Many individuals and families will lose wages due to illness or the temporary closure of their employer. Providing financial support to help them pay bills and survive financially through the end of the pandemic seems perfectly reasonable. Small businesses, corporations, and the banks that finance them may also need financial support. Losing two months or more of revenue from an unforeseen pandemic might be enough to push otherwise healthy companies into bankruptcy. That process can result in layoffs that affect workers long after the pandemic has passed.

Directing the financial support to only one of these groups is less likely to prevent a long-lasting economic impact from a hopefully short-term pandemic. I think we want families and businesses to all emerge from this period without long-term disruptions.

Q: Is America entering a recession as a result of this pandemic?

A: There is some uncertainty about how the economy will respond to the pandemic. It's pretty clear that it will have a substantial short-run impact on several industries and many workers. The length of the pandemic and the associated restrictions may determine whether we officially move into a recession. If everything is "back to normal" in a couple of months and business resumes as usual, it is possible that we see a very short-term downturn that quickly reverses. If we stretch across several quarters, it seems likely to me that we will officially enter a recession because of the sustained drag on the economy.

Q: Do you think fallout from the pandemic might include people advocating for closed economies?

A: It's tough for me to speculate, but there are substantial gains to working with other countries, and many countries' past attempts to run a closed economy haven't turned out particularly well.

Q: How will we know when things are beginning to turn around in the global economy?

A: We should look for reversals of the recent trends. If investors gain a better sense of how the pandemic will evolve and what its ultimate economic impact will be, we would likely see indications in a few places. Stock market volatility would go way down. A normal level of VIX, for example, would be in the 15 to 25 range. Treasury bond prices would fall and yields would increase. We are in an era of low interest rates, but Monday's 10-year Treasury yield of 0.73% is near historical lows. A quick return to 1.50%, where it was a month ago, would indicate that investors have calmed. And, hopefully, we would see positive stock returns to offset some of the recent losses.

Provided by University of Arizona

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