Risk Appetite—For Now—It's the Only Game in Town

Impressive back to back gains for the US equity markets, taking the S&P 500 some 16% off Monday's low, have prompted a broad sigh of figurative relief in markets—sending volatility lower, undercutting FX safe havens and lifting the high beta currencies. It would be nice to think that the worst is over but it's really too soon to say—we can only call the definitive low for stock markets with the benefit of (a lot of) hindsight. Risk currencies can firm a little more in the short run we think but scope for broader gains is less certain—and more likely limited for now.

As bear markets go the February/March swoon in the S&P 500 has been brutally quick but remarkably average in terms of its scale. The index peeled off 35% in value in just 25 days from the February high to the March 23rd low, compared with the average length of bear markets since the 1980 of 336 days. However, the 35% decline puts it bang on the average decline in the index in bear markets over that period. That will cheer anyone looking for a low point in equity markets but it's not clear—and probably won't be for some time—that the low is in at this point. A new bull market phase—where the previous high is surpassed rather than markets simply making a gain of more than 20%—is still further away.

Optimists will note that this is not a typical economic downturn, rather a sudden stop amid otherwise healthy fundamentals which former Fed Chairman Ben Bernanke likened to a natural disaster—albeit a severe one—rather than a depression. The rebound from a sharp contraction in global output is expected to be relatively rapid. Moreover, the combined level of fiscal and monetary policy support provided by the global authorities has been impressive—and more may come. This will provide a significant backstop for risk assets in the coming months. Finally, margin calls and forced selling of assets appears to have abated; central banks have stepped up to ensure ample market liquidity is at hand, even if there are signs that global banking systems' "plumbing" is still backed up a little in some areas. Looking at what is right about an "average" haircut for stocks in recent downturns, bargain hunters have been active.

If the past really is any sort of guide, it should also be apparent that marking the low point for stock market downturns is not an obvious exercise. No one rings the bell at the top—or the bottom—of markets. Since the 1980s, equity market recoveries have typically been pretty slow and pretty messy in developing. Average gains following the low point for the bear markets noted above, right are 30% six months after the low but are more typically a little more than 20%. A high close for stocks this week will bolster expectations for additional gains in the short run because technicals will look compelling. But we might already have seen half or three quarters of the gains we might expect to emerge through the Oct/Nov period already.

There are a number of risks that can easily derail optimism. How well the Western economies manage (or not) the virus is one risk, the re-emergence of cases in China as the lockdown there ends is another. Economic expectations appear suitably subdued for the near-term and a lot of bad news is probably factored into market thinking now. But weaker than expected data or a more persistent slowdown that limits forward visibility on earnings even further will curb the ability for stocks to rebound.

Unfortunately, for the FX markets, equity market trends and volatility are likely to remain the primary driver of market movements for the next few months at least. All

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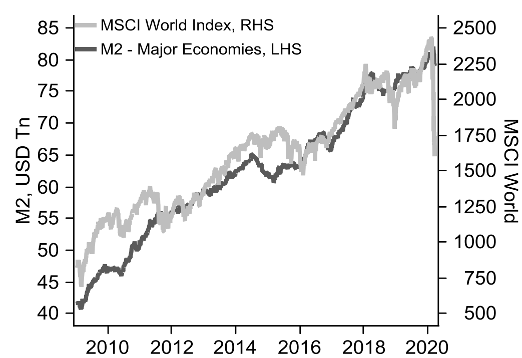
S&P 500 Bear Markets Since 1980

Date	Pct Decline	Days
1980/82	-27	622
1987	-34	101
2000/01	-37	546
2002	-34	278
2007/08	-52	408
2009	-28	62
Avg	**-35**	**336**
2020	-35	25

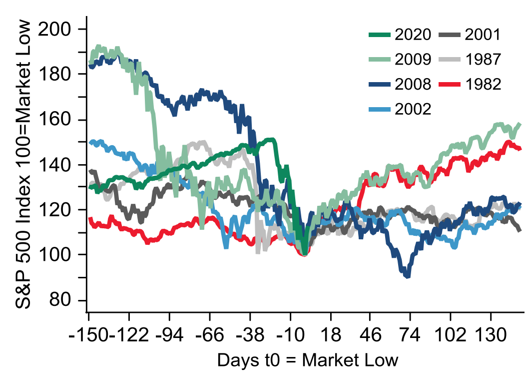
Source; Scotiabank FICC Strategy calculations

Central Bank Liquidity Backstops Risk



Source: Macrobond, Scotiabank FICC Strategy

How Bear Markets End



Source: Macrobond, Scotiabank FICC Strategy major economies are similarly positioned now and all major central banks are more or less on the same page (we assume the Bank of Canada will cut another 50bps in the coming weeks), making fundamental differentiation less obvious than usual.

That likely means a window for commodity FX to gain a little more ground in the short run while the JPY and CHF should remain better supported on dips in the medium term because there will be bumps and setbacks in the recovery process even if everything goes well. We think the USD's role as a haven will diminish as dollar funding pressures ease amid a flood of central bank liquidity aimed precisely at easing offshore funding demand.