

# Daiwa's View

## Excessive pessimism unlikely to continue

- “Instability breeds stability”
- “Fed put” implied

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Daiwa Securities Co. Ltd.

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### Excessive pessimism unlikely to continue

One of economist Hyman Minsky’s proverbs is “Stability breeds instability.” In [our 6 January report entitled \*Things to watch for in 2020: Part 1\*](#), we wondered “Whether market sentiment will again be driven by fear.” This was because I felt that extreme market optimism around the turn of the year was unlikely to continue.

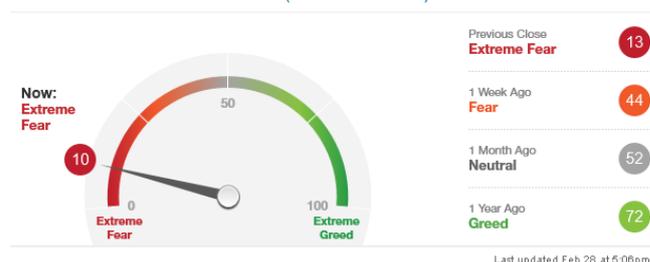
In just two months, the market atmosphere has drastically changed. At the beginning of the year, we referred to CNN’s “Fear & Greed Index” as an example showing extreme optimism. Confirming the index, we found that it plunged from 97 (extreme greed) to 10 (extreme fear). All the seven components of the indicator have also changed to “Extreme Fear.”

Chart 1: Fear & Greed Index (beginning of 2020)



Source: Extracted from CNN.

Chart 2: Fear & Greed Index (end-Feb 2020)



Source: Extracted from CNN.

The CBOE Volatility Index (VIX), one of the components, rose to the 40 level. The term structure of the VIX Index Futures (second-nearest contract minus nearest contract), which is highly effective as an indicator for the degree of market panic, has dropped to  $-3.1$  (Chart 4). As this level was seen only once in several years when the market was in panic mode (e.g., China shock in 2015-16), it shows that the market is currently driven by fear. If the fear spreads, the market would rush into risk aversion. Currently, there is no argument whether the public is keeping calm<sup>1</sup>.

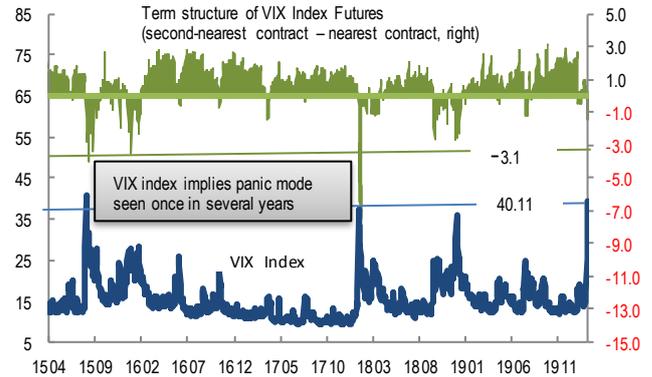
<sup>1</sup> Daio Paper, estimated to have top share in Japanese toilet paper market, produces products in Ehime Pref. Nevertheless, toilet paper products have disappeared at retail stores. This fact shows that panicked sentiment is widespread among people.

Chart 3: Component Factors of Fear & Greed Index

	03-Jan-20		28-Feb-20
1 Stock Price Strength	Extreme Greed	⇒	Extreme Fear
2 Junk Bond Demand	Extreme Greed		Extreme Fear
3 Put and Call Options	Extreme Greed		Extreme Fear
4 Stock Price Breadth	Extreme Greed		Extreme Fear
5 Market Momentum	Extreme Greed		Extreme Fear
6 Safe Heaven Demand	Greed		Extreme Fear
7 Market Volatility	Neutral		Extreme Fear

Source: CNN; compiled by Daiwa Securities.

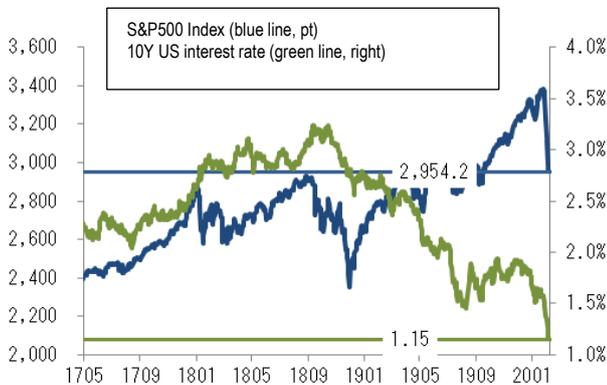
Chart 4: VIX Index and Term Structure



Source: Bloomberg; compiled by Daiwa Securities.

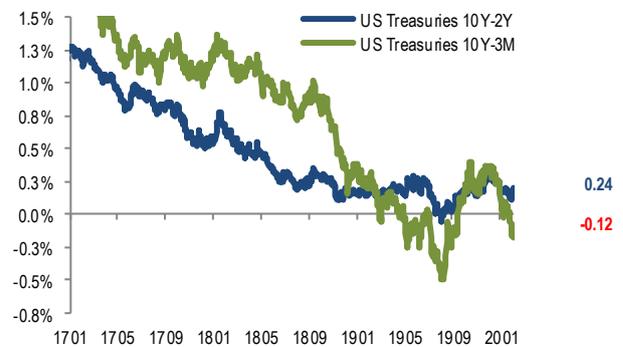
The expansion of the impact of the COVID-19 virus outbreak on the market to this level was supposed to create downward pressure on the economy via the path of “credit deterioration → worsening of financial environment index → plunge in stock price indices → decline in individual assets → deterioration in consumer confidence indices → decline in personal consumption.” In such a situation, a subtle change has been observed since 25 February among remarks by Fed officials, including Vice Chair Richard Clarida. On 29 February, Fed chair Jerome Powell announced [an emergency statement](#), which again included the language of “act as appropriate,” signaling preventive rate cuts. While the global economic growth rate is presumed to slow down alongside the decline in US inflation expectations to 1.43%, the Fed sensed a crisis of achieving the dual mandate and thereby took action ahead of others.

Chart 5: 10Y US Inflation Expectations



Source: Bloomberg; compiled by Daiwa Securities.

Chart 6: Differential Between US Long-term and Short-term Interest Rates



Source: Bloomberg; compiled by Daiwa Securities.

Of course, monetary easing has no ability to influence the COVID-19 outbreak. However, it would probably be able to calm the excessive fear flourishing in the financial market and prevent a self-fulfilling economic collapse. Reflecting the statement by Mr. Powell, the US 2-year/10-year spread widened to 24bp, steepening from the bottom on 20 February (12bp). This is the first signal that excessive pessimism over the US economy (= credit) has diminished.

I think that Mr. Minsky's proverb “Stability breeds instability” implies that “Instability breeds stability.” Although I do not optimistically view the current developments on COVID-19, it is true that excessive pessimism, like the current case, has never continued. As the Fed is taking the matter seriously, it has implied a “Fed put.” This has changed the situation to a new phase. We can say that risk has now heightened regarding overly betting on excessive pessimism.

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### ■ Credit Rating Agencies

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\* The amount of the trading commission cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

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