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From black swan to bubble: as virus concerns fade, investors worry about a melt-up

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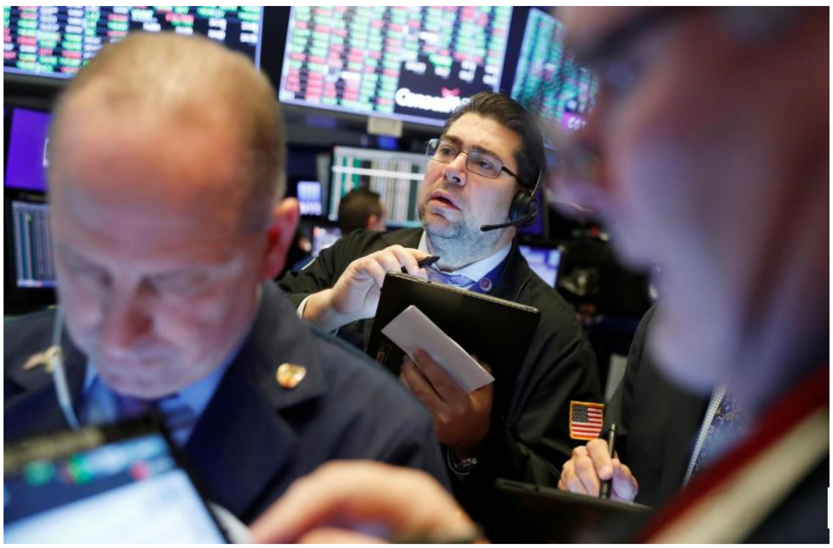
NEW YORK (Reuters) - When worries over the coronavirus shook U.S. stocks out of a period of quiet trading last week, investors wondered if the outbreak was the “Black Swan” event that would trigger a sharp decline. Less than a week later, talk has turned instead to a market melt-up.



FILE PHOTO: Traders work on the floor of the New York Stock Exchange shortly after the opening bell in New York, U.S., February 6, 2020. REUTERS/Lucas Jackson/File Photo

After that brief swoon, the market made a roaring recovery, and there were also rallies in Tesla Inc, bitcoin and other assets often seen as barometers for risk appetite.

The sharp snapback has revived concerns among some investors that market participants are growing overly confident that easy money policies from central banks will underpin prices, despite serious risks to global growth from the coronavirus.

“There could be more downside if the (outbreak) spreads, but for now the trend is still up. The bigger risk is arguably that we end up in a mini-bubble,” said Troy Gayeski - Co-CIO of SkyBridge, an alternative investments firm.

Gayeski said that coming into the year SkyBridge had positioned its portfolio to take advantage of gains by using equity call options.

“We did put some equity call exposure in the portfolio coming into the year, because if one of the risks is a bubble developing then why not try to participate?”

The S&P 500 stands near a record high after rallying nearly 4% from its lows of last week. The Dow Jones Industrial Average and Nasdaq Composite have also hit highs while the CBOE Volatility Index, a gauge of investor anxiety, has drifted lower after spiking last week to its highest in nearly four months.

Michael O'Rourke, chief market strategist at brokerage firm JonesTrading, noted markets have shot higher despite uncertainty over how long travel restrictions and shutdowns will weigh on large portions of China's economy. Easy monetary policy from the U.S. Federal Reserve has made investors bolder about taking risks, he said.

"Every time there's been a downturn in the market, the Fed has stepped in to ease," he said. "Investors have been trained in a Pavlovian manner to not assess risk and buy every dip you get."

The World Health Organization said Wednesday was the first day the overall number of new coronavirus cases in China dropped, although the outbreak continues to rage in Hubei province.

It's still unclear, however, how long the shutdowns that have paralyzed Hubei and other areas will remain in place, or the effects they will have on growth in China and abroad.

"My client conversations are all about, 'is this the black swan? Is this what can derail the global expansion?" said Torsten Slok, chief economist at Deutsche Bank Securities. A "black swan" event refers to an unforeseen occurrence that typically has extreme consequences.

Right now, "we don't think this is a Black Swan."

Investors will worry if China extends shutdowns or expands them to other areas, said Jens Nordvig, founder of analytics firm Exante Data.

"Most people expect things will normalize by next week," he said. "If there was an announcement of another extension...that will freak people out."

Trying to time the market's declines and betting against more gains has been a losing strategy over the more than decade-long bull run in stocks, despite repeated worries about rich valuations and overexuberance.

Still, some investors are taking a cautious view of the recent advance. George Schultze, founder of Schultze Asset Management in New York, said now may be a good time to lock in gains on the rally.

"For investors that have had big gains and are mostly in passive ETF strategies, now may be a good time to put some cash on the side and realize some gains," said Schultze.