The lender of last resort’s last resort

The Fed delivered a Sunday surprise to markets, slashing its benchmark interest rate range close to zero and preparing for $700 billion in asset purchases, including both U.S. Treasury and mortgage-backed securities. It also announced measures to help provide liquidity to the financial system through coordination with other central banks and more generous liquidity provisions to banks and other financial institutions.

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WHAT HAPPENED?

The Federal Reserve’s Open Market Committee (FOMC) held its scheduled March meeting three days early and announced a variety of policy changes on Sunday to combat the economic effects of the coronavirus. It cut its policy rate range to 0.00% – 0.25% and will make permanent asset purchases totaling at least $700 billion. U.S. Treasuries will account for $500 billion, while mortgage-backed securities will comprise the remaining $200 billion. The Fed pledged to keep rates at the lower bound until, according to its statement, “it is confident that the economy has weathered recent events.”

In comments to the press after the meeting, Chair Jerome Powell reiterated the Fed’s role in ensuring financial market liquidity and supporting the economy as it struggles under the stress of the coronavirus and begins to recover. At the same time, he sounded a familiar refrain from central bankers over the past few weeks: This crisis is at its core a health care concern, making monetary policy an imperfect tool for counteracting it.

Even prior to the weekend’s actions, the Fed had been increasing the amount of liquidity it provides on an ongoing basis to the banking system and financial markets. Last week, the Fed announced up to $1.5 trillion in temporary open market operations – loans through collateralized repurchase agreements – to primary dealers. On Sunday, it slashed the interest rate on the discount window, the direct overnight lending facility it maintains for banks, by 150 basis points (bps) to 0.25% in order to encourage more banks to use it. It also announced coordinated action with other global central banks to ensure U.S. dollar liquidity in markets around the world.
WHAT COMES NEXT?

These measures comprise a long-anticipated monetary policy “bazooka,” meaning there is now little else the Fed can do to combat a severe economic downturn in the coming months. It can increase the amount and pace of asset purchases as it did during the aftermath of the financial crisis, but it’s unlikely to lower rates below zero and has very limited ability to help the economy in more targeted ways, for example, through direct loans to small businesses experiencing revenue disruptions. The Fed could potentially coordinate with the Treasury Department to make direct loans to a wider variety of businesses, but post-crisis financial reforms constricted its ability to do so.

With monetary policy now largely spent – not just in the U.S. but around the world – investors’ attention will focus on the public health crisis and the fiscal policy response from the world’s governments. We believe the depth and duration of the ongoing economic downturn will be chiefly determined by health care policy measures to halt the spread of the coronavirus. Mitigation factors to help contain the virus’ spread are having a dramatic negative effect on consumer and business spending, which we expect will spill over into the labor market.

Both monetary and fiscal policy can help improve the trajectory of the economic and market recoveries when they finally arrive. Low interest rates can help households and businesses manage their existing debt or even refinance. And easy monetary policy is important to making fiscal policy more effective, because it helps to smooth the road for a large increase in the market supply of government debt.

Our assumption for global economic growth for the remainder of the year includes a sharp decline in Q2 followed by a highly uncertain path to recovery – in both timing and strength – starting in Q3 in our base case. We are expecting more from U.S. fiscal policy (direct cash transfers to both employers and workers) in the coming weeks to offset the sharp deceleration in economic activity and for those measures to be matched by stimulus in Europe and Asia.

INVESTMENT IMPLICATIONS

Monetary policy is now firmly back in crisis response mode, as it was for more than five years following the financial crisis. Because this crisis is not financial at its core, the current emergency posture from the Fed and other central banks – specifically the aggressive pace of asset purchases – should not last quite as long. However, the bar the Fed has set for removing the accommodation and raising interest rates is very high. In short, low short-term rates are here to stay for the foreseeable future.

Liquidity in fixed income markets deteriorated last week, particularly in corporate credit, which has been affected by fears of rising default risk in the energy sector. Powell acknowledged in his press conference that even the normally liquid U.S. Treasury market has come under stress amid forced selling from investors exiting positions to cover losses elsewhere. The Fed’s measures over the past week will provide a stronger bid for Treasuries and more generous liquidity provisions across the financial system, which should help functioning in other fixed income markets.

The 10-year U.S. Treasury note yield dropped over 30 bps in Sunday evening trading, following the Fed’s announcement. We regard that as a positive sign that the Fed’s actions may help market liquidity almost immediately. However, the day to day volatility will continue to be driven by uncertainty around the coronavirus impact itself. U.S. equity futures opened on Sunday afternoon down at their “limit” of 5%, though it is unclear whether that was a vote of no confidence in the Fed’s actions or a broader reaction to the negative coronavirus news flow following Friday’s strong close.

We still consider it too early to significantly increase risk in equity and credit markets given the escalation in new coronavirus cases in the U.S. and Europe and the durable drop in global energy prices.