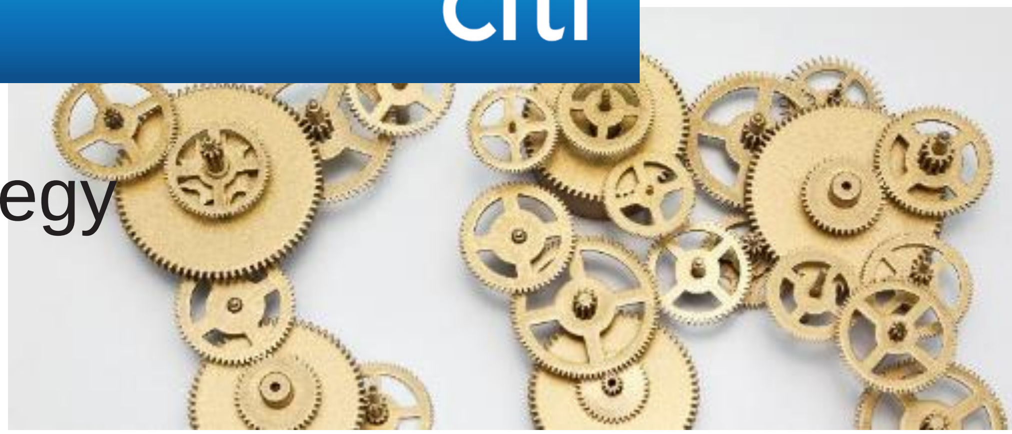
Private Bank



Global Strategy Bulletin

March 3, 2020

Central Banks Try to Vaccinate World Markets…

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Summary*: In an acknowledgement of the building economic shock from the coronavirus, the Federal Reserve cut its target policy rate 50 basis points at an unscheduled meeting today. Further action is likely. (This followed rate cuts by 25 other central banks during the course of 2020, including two acting overnight). G-7 finance ministers in a statement earlier today said they would "use all appropriate policy tools" to safeguard growth.*

We see macro policy, particularly fiscal "disaster relief" as a constructive, important element to prevent lasting damage from an exogenous, global health shock. Easier monetary policy has little immediate economic impact, but it does lower "hurdles" for risk taking activity. It should also encourage governments to take bolder, ideally temporary fiscal measures. Importantly for global markets, given a high Fed funds rate compared to global yields, ***failing to cut interest rates might have attracted disruptively strong inflows into safe-haven USD assets.*** *This could have risked further tightening financial conditions.*

As the Fed is likely to unwind emergency easing measures much more slowly than it acts, rate cut(s) will help strengthen eventual recovery. Notably, however, ***US equities have declined in four of seven cases in the week that has followed emergency Fed rate cuts****. The same may now occur. However, the context for the majority of past emergency rate cuts has historically been significantly more negative than we see in the current situation.*

…With More Coronavirus Impact Ahead

- The US Federal Reserve cuts the fed funds rate target 50 basis points ahead of its March 17-18 scheduled meeting (new target 1.0%-1.25%). During a press conference, Fed Chairman Powell said he felt the new stance of policy is appropriate, but said that the central bank would still take into account incoming information on the evolving virus impact. Fixed income markets price in an additional 50 basis points of cuts this year which seems likely in light of our own economic outlook (please see Strategy Bulletin: Better to be a Buyer Tomorrow Than a Seller Today and Strategy Bulletin: New Global Shock, Our Evolving Assumptions for Investors).
- The Fed move follows easing steps from Australia and Malaysia overnight, earlier actions from China and other Asian central banks since the Covid-19 outbreak. G7 Finance Ministers and central bankers earlier said they would take "fiscal measures where appropriate" to combat the negative impact of the virus[1]. We see "disaster assistance" as the most effective "bridge" to avoid self-reinforcing (recessionary) impacts beyond the initial disruption from the virus itself.
- As figure 1 shows, the Fed funds rate at 1.50%-1.75% stood out as "capital flight safety zone." Those looking to disengage from risk taking were shifting funds into short-term US Treasuries at the expense of other borrowers. At higher levels, this could have proven disruptive to many borrowers across the world given the USD's dominant status in trade finance and as a reserve currency.

[1] Group of Seven nations (G7) consists of representatives from Canada, France, Germany, Italy, Japan, the UK, and the US

- Rate cuts by central banks specifically can have only a limited, immediate economic impact. They potentially keep risk taking "alive" with lenders continuing to provide credit at somewhat higher levels (*ceteris paribus*). Lower rates also pass through easily in US mortgage markets.
- Quantitative easing in Japan and the Eurozone might have the same marginal positive impact, but current monetary policy in the two regions is already consistent with emergency measures. Therefore, fiscal policy makers there should be under far greater pressure to act more strongly.

Figure 1: US Dollar and US interest rates

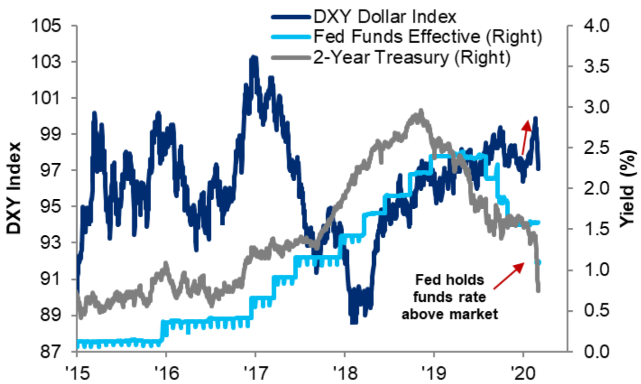
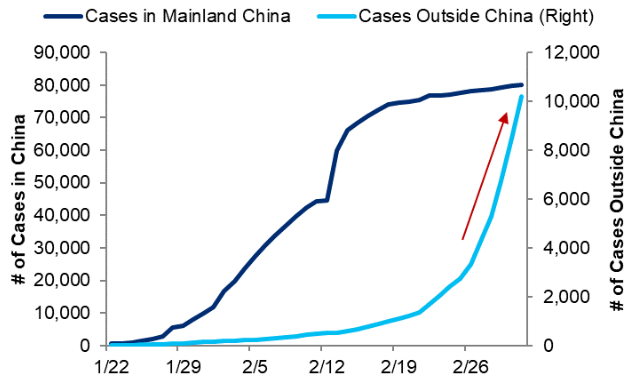


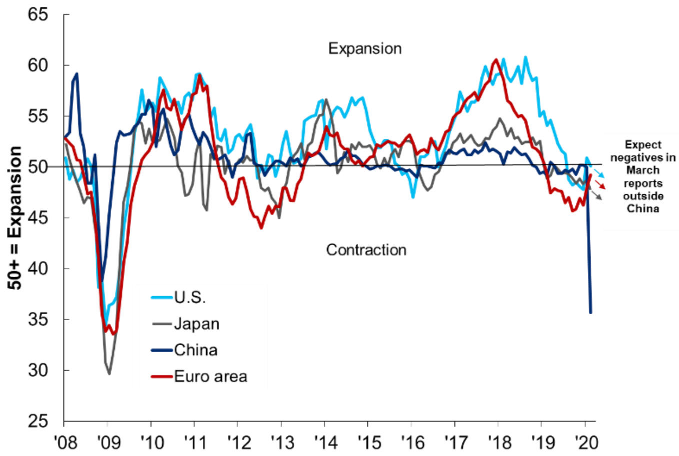
Figure 2: COVID-19 cases within and outside China



Source: Haver Analytics and Factset as of January 27, 2020.
Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. Past performance is no guarantee of future returns. Real results may vary.

- As figure 2 shows, coronavirus infections outside China have been accelerating much as China's did a month earlier in timing. While the public and public policy reaction may vary sharply from China's in individual countries, the severe economic disruption in China's economy seems likely to be repeated elsewhere (see figure 3).
- As noted above and in our updated economic outlook, we see "interruption" for a natural disaster quite differently from an economic bust driven by excessive spending and production. However, policymakers do indeed have to protect economic capacity as a "bridge loan" or "disaster relief" might. This would prevent second order economic deterioration, such as a cascade of insolvencies among lenders exposed to virus-impacted borrowers.
- **Investors should be careful not to make any assumptions that emergency monetary easing somehow prevents the negative economic impact driving the Fed's action.** As figure 4 shows, US equities have fallen on the day of an emergency Fed rate cut in 3 of 7 cases since the Fed began regularly announcing its policy target in 1994. They've fallen in 4 of 7 cases in the week that followed.
- As the table also shows, equity markets have fallen in the full year following 5 of 7 cases that followed emergency Fed easing steps. First, we would be careful to note that emergency easing is *not the cause* of this outcome. Second, and more importantly, 6 of the 7 unscheduled rate cuts were related to two systemically important recessionary periods. The first included the unwinding of the US bubble period, when US equity valuations had reached history's highest levels. The second was the more recent Global Financial Crisis, when developed economies faced a shock to bank solvency at level not seen since the 1930s. We see the new global health challenge of Covid-19 in a very different (less severe) light as detailed in the notes linked above.

Figure 3: Global Manufacturing Purchasing Managers' Indices (PMIs)



Source: Haver Analytics as of March 3, 2020.

Figure 4: S&P 500 returns following inter-meeting cuts

	Forward Returns (%)			
Inter-meeting cut	One Day	One Week	3 Month	12 Month
10/15/1998	0.9	3.0	17.8	19.1
1/3/2001	(1.1)	(2.5)	(17.9)	(13.5)
4/18/2001	1.3	(0.8)	(1.9)	(9.2)
9/17/2001	(0.6)	(3.4)	8.1	(15.9)
8/17/2007	0.0	2.3	0.4	(10.2)
1/22/2008	2.1	4.0	5.9	(35.9)
10/8/2008	(7.6)	(7.8)	(5.1)	8.2

Figure 5: US Treasury yields following inter-meeting cuts

	Forward Yield Change (bps)			
Inter-meeting cut	One Day	One Week	3 Month	12 Month
10/15/1998	(14)	4	16	151
1/3/2001	(11)	(4)	(20)	2
4/18/2001	13	14	8	9
9/17/2001	9	10	61	(76)
8/17/2007	0	(6)	(54)	(84)
1/22/2008	17	24	29	(90)
10/8/2008	16	31	(119)	(39)

Source: Haver Analytics and Factset as of January 27, 2020.

Appendix 1: US IG corp returns following inter-meeting cuts

	US IG corp Forward Total Return (%)			
Inter-meeting cut	One Day	One Week	3 Month	12 Month
10/15/1998	0.8	(0.1)	2.4	(0.0)
1/3/2001	0.6	0.8	3.8	9.8
4/18/2001	(0.5)	(0.1)	2.8	7.4
9/17/2001	(0.4)	(0.4)	(0.3)	7.4
8/17/2007	0.0	0.5	3.4	2.7
1/22/2008	0.5	(0.3)	(1.2)	(5.8)
10/8/2008	(1.0)	(3.2)	5.9	24.7

Appendix 2: US HY returns following inter-meeting cuts

	US HY Forward Total Return (%)			
Inter-meeting cut	One Day	One Week	3 Month	12 Month
10/15/1998				
1/3/2001	0.5	1.7	5.7	5.2
4/18/2001	(0.1)	0.3	(0.7)	3.3
9/17/2001		(5.2)	(1.2)	(6.9)
8/17/2007	0.0	1.0	2.4	0.0
1/22/2008	(0.1)	1.7	3.2	(19.9)
10/8/2008	(1.8)	(6.2)	(5.8)	33.6

Source: Haver Analytics and Factset as of January 27, 2020.
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Malcolm Spittler, Joe Fiorica, Joe Kaplan, Charlie Reinhard, Kris Xippolitos contributed to this bulletin