

US: Covid-19 & Oil Wars Warrant Decisive Action. Fed moves to ease financial stress



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- **Uncertainty surrounding the magnitude and duration of the global health crisis is driving volatility and testing liquidity** across the world's financial markets. In addition to the supply chain disruption and demand destruction resulting from the coronavirus, an additional, and also severe, supply shock has been introduced to the US and global economy. Saudi-led OPEC has embarked on an oil price war with large non-OPEC oil producers, putting investors on high alert for a global recession, and raising the odds of a US recession.
- **Central Banks in action: On Sunday, March 15, coordinated action among G-10 central banks, plus the Federal Reserve's dramatic announcement of zero-bound interest rates and quantitative easing, aimed to stabilize market liquidity and confidence.** The Fed also reduced bank reserve requirements to zero, thereby freeing up liquidity for every bank in the country. This allows banks to make more loans, and improves their margins as cash moves from the Fed's near zero rate on bank reserves to higher yielding assets. This comes after the Fed's meaningful commitment on Friday to infuse \$1.5 trillion into short-term funding markets.
- **Last night measures were not able to calm financial markets.** Equities are posting significant losses in Europe, volatility is reaching the record levels touched during the Great Financial Crisis and US Treasury yield is trending lower. These measures aim at restoring liquidity in the system, easing financial stress and avoiding that the productive part of the economy suffers from permanent disruption. However, these measures can do little to support the demand side or restore supply chains: over reaction and volatility are here to stay, until we see the containment measures producing some effects, fiscal stimulus becoming more prominent and coordinated (we expect measures from today Ecofin) and prospects of medical treatment.
- **Markets are also looking at what happened in China. Recent data released showed that the industrial production, retail sales and capital expenditures tumbled in the first two months of the year.** Now the activity is resuming but the damage has been high and this is what markets expect for the rest of the world now dealing with Covid-19. So little comfort for markets, until some more concrete signs of recovery materialize in China, to show the possible path ahead.
- **Fiscal policy is now "on the clock."** All eyes are on Washington and on the potential for easier fiscal policy beyond what has already been approved by the House of Representatives. Follow-through from the US Executive branch and Congress – and government bodies around the world - with fiscal stimulus will be critical to sustain and accelerate the central banking system's leadership.
- **We are encouraged by the powerful infusion of liquidity and apparent solidarity of the central banking system. As we see the market and fiscal response play out, we will continue - with purpose and patience - to keep a strong focus on liquidity and high flexibility.** Active long-term investors should continue to carefully identify mispriced securities and reposition portfolios to ensure ample liquidity as well as to take advantage of the dislocation in asset prices for the benefit of long-term investment returns.

“The liquidity infusion can go a long way in easing funding stress.”

The Federal Reserve in action to ease financial stress

Cutting rates by 100 basis points to near zero on Sunday, March 15, the Fed cited the effects of the novel coronavirus on growth in the near-term, and risks to the long-term economic outlook. The Fed telegraphed that rates will remain at near-zero levels until the Committee “is confident that the economy has weathered recent events and is on track to achieve its maximum employment and price stability goals.” **In response to severe tightening of financial conditions, the Fed also jumpstarted its Quantitative Easing (QE) program** by immediately increasing its holdings of Treasury securities by at least \$500 billion, and agency mortgage-backed securities by at least \$200 billion. The Fed cited its objective to support the flow of credit to households and businesses. We can expect continued reinvestment of all principal payments from Fed holdings of agency debt and agency mortgage-backed securities. Importantly, the Fed, along with five other G10 central banks, will offer more attractive terms for USD swap lines, aiming to prevent disruptions in dollar funding markets.

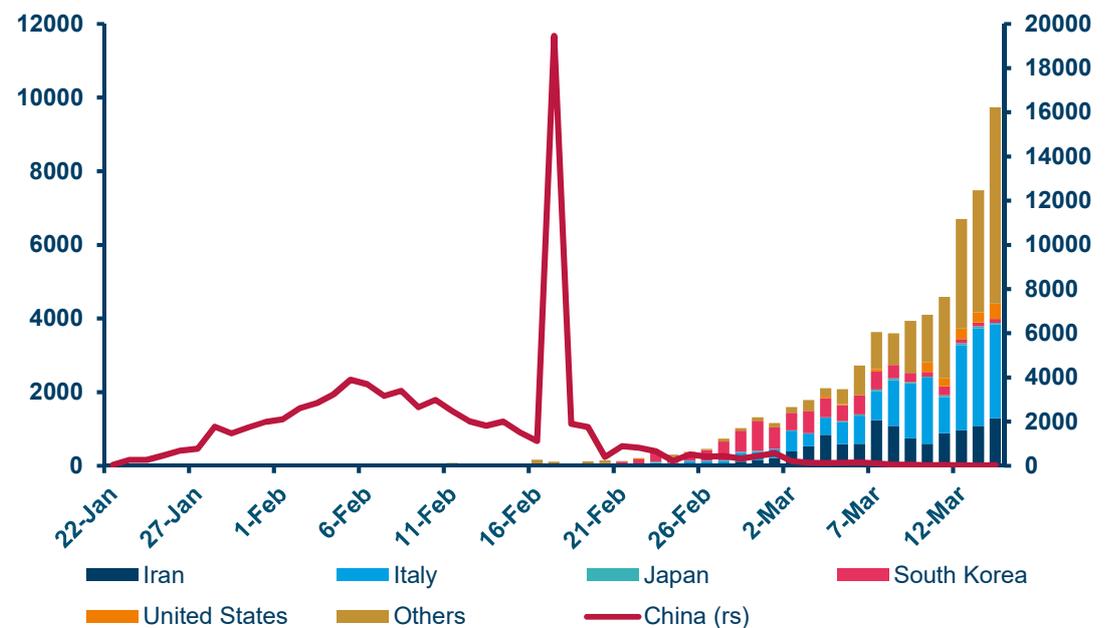
The Fed’s actions of late last week and this weekend serve to address the tightening in financial conditions, **the sharp decline in real rates and the collapse of inflation expectations to below 1%. Finally, the liquidity infusion can go a long way in easing funding stress in money markets and narrow the cross currency basis significantly.**

Three phases of the epidemic: we are now in the middle of phase 2, looking for recovery

The initial shock of the Covid-19 infection and uncertainty surrounding its containment and potential impact on the Chinese economy was characterized by a “phase I” market response. Safe haven securities such as US treasury bonds rallied, and the yield curve flattened as many investors sought to reduce risk and feared the economic impact of supply chain disruptions. Equity markets, defending all-time highs, were less perturbed by the “global health emergency” and buoyed by corporate earnings and continued economic growth.

We are now deep into a more serious phase of the crisis, with expansive infection met with generally swift and severe containment measures. In the US, proactive action has largely been limited to individual states and travel restrictions affecting non-US citizens coming to the US from Europe. Soft survey data are indicating sharply weaker growth in China and, significantly, to the global economy. Volatility has soared, with US stock market circuit breakers triggering twice over the past week, and 10-year Treasury bond yields breaching the 0.40% mark, 1.50% lower than the start of the year. Credit spreads have widened dramatically.

Covid-19 daily confirmed cases



Source: World Health Organization Daily Situation report. Data as of 14 March 2020.

“A massive policy response should be able to stabilize the markets, and a decisive trigger could be the prospect for vaccination and/or treatment.”

As a global community, we look forward to the final phase of recovery, when incidence of infection rolls over and recoveries accelerate. Markets should feel relief, especially if there is the prospect for vaccination and/or treatment. Markets and growth can recover as central banks and governments double down on fiscal stimulus, with less dependence on and impact from monetary measures. US Congress and the Executive branch must find common ground to “pull out all stops” to mute the spread and impact of the virus. Bipartisan agreement is needed to enact programs such as targeted lending, tax deferrals, payroll tax cuts, healthcare assistance and paid sick leave. When all is said and done, there may be some changes in supply chains and long-term consumer behavior. We believe most of the virus-related impact on the global markets is transitory, most severe in the first half of 2020, and likely bleeding into the third quarter.

Oil-Related Supply Shock Compounds Covid-19 Demand Shock

As Covid-19 weighed heavily on demand for oil, negotiations between Saudi Arabia and Russia broke down. Russia balked at reducing output, and Saudi Arabia responded with the opposite tact, not only raising output but also offering oil at a discounted rate below \$35 per barrel. Oil prices have plummeted over 25%, during which time we witnessed the largest daily drop since the First Gulf War in 1991.

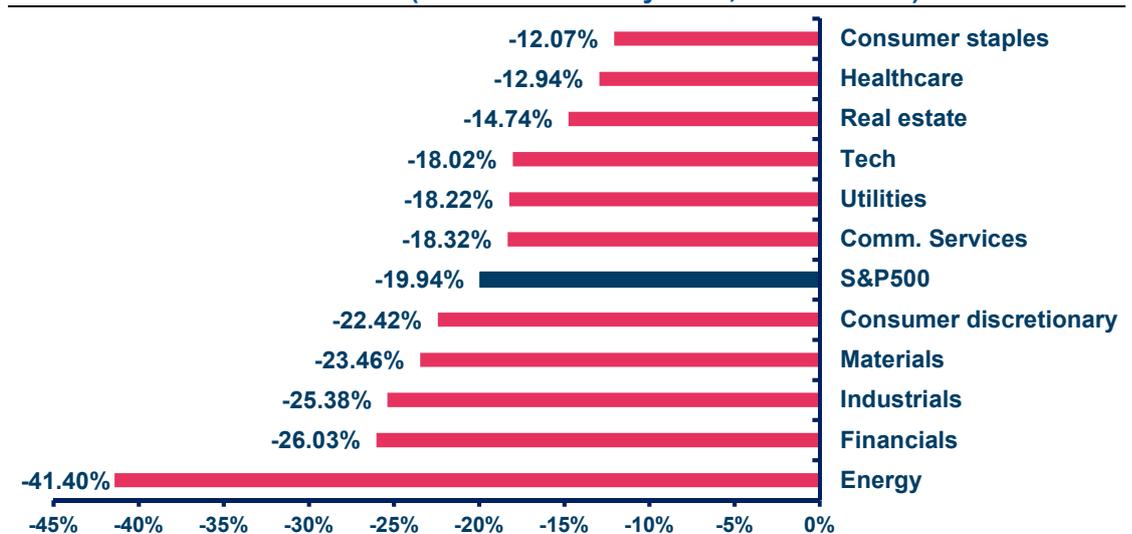
Falling oil prices could have a mixed impact on the US economy. The immediate negative impact will be an energy recession if oil prices remain at these levels over the next few months. The exploration and production companies are especially vulnerable, with high extraction costs, significant debt and increasing liquidity concerns. Business failures in this sector will impair capital expenditures (the energy sector contributes approximately 5% of total capex), amounting to 0.5% of GDP. US labor and credit markets are vulnerable to an energy recession as the sector employs 640k workers, or approximately 0.5% of the total labor force. The last energy recession occurred in 2015-16 when the sharp decline in oil prices led to a 25% fall in energy capex; economists estimate 110k in job losses at this level of capex decline.

Some of these negative effects will be offset by the positive impact of a “tax cut” to the consumer of lower oil prices, which could stimulate spending. Tobacco companies and automakers tend to benefit from lower prices at the pump, where most cigarettes are sold. In addition, cheaper fuel prices can offset some of the corona-related roiling of the airline and shipping industries, as well as benefit the struggling agriculture and manufacturing sectors.

Financial markets are more heavily weighing energy sector business failures over increased consumption and lower costs. Credit spreads continue to widen, led by the energy sector, and equity markets are reaching new lows.

“Financial markets are more heavily weighing energy sector business failures over increased consumption and lower costs.”

Sector returns of the S&P500 (since 19 February 2020, record close)



Source: Amundi on Bloomberg data, as of 13 March 2020.

“The chance of a US recession has risen, but is not our base case.”

Not Your Textbook Recession

We are navigating unknown territory, with the current crisis triggered by a highly infectious disease, and being exacerbated by the political overlay of a US election and international battle for dominance of the world's most valuable commodity. Current risks are unlike “normal” recessions that emerge from conditions such as excessive advantage, asset bubbles, a liquidity crunch, nervous consumers or runaway inflation. The lack of playbook for policy response and absence of precedence make it difficult to predict the magnitude, duration – or probability of a recession. The chance of a US recession has risen, but is not our base case. Heading into the current crisis, global GDP was showing signs of improvement. In the US, consumers were confident and spending, and small businesses optimistic and investing, driving steady growth. The dual blow of a pandemic and collapsing commodity prices has reversed the momentum and increased the prospect for negative growth in Q2. **As we expect the threat of the virus to wane over the next few months, a recession is likely to be shallow.**

Recessionary forces such as excess investment, an aggressive Fed, and spiking oil prices do not currently exist, and we do not anticipate an extended retrenchment of consumer spending on entertainment, dining and travel. **A continued refinance boom and falling gas prices are two additional factors that mitigate the risk of a US economic recession.** Mortgage loan applications for refinancing have surged 223% year-over-year, and the sharp decline in wholesale gas prices suggest significant savings as retail gas price may approach \$2.00/gallon.

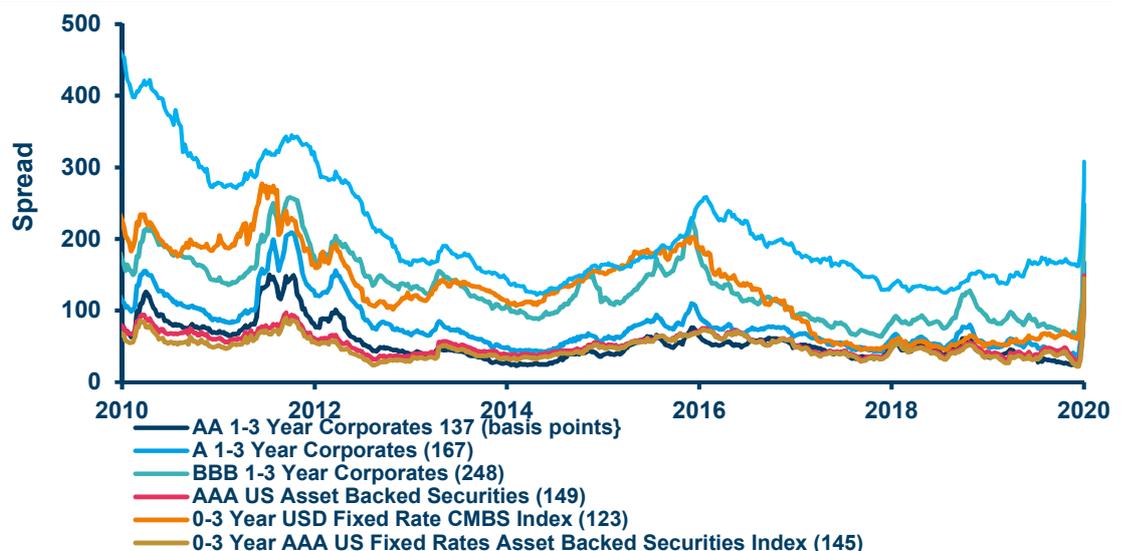
Fixed Income: Selective credit opportunities from dislocation, with liquidity focus

We expect continued elevated levels of volatility in fixed income markets, rather than permanent impairment. While there are vulnerabilities, particularly in energy (exploration and production), we expect fundamentals to regain their pre-corona stability, and valuations to rebound. **Credit spreads have widened considerably, and US fixed income is trading at deep discounts.** While there may be further room for spreads to move, there is undoubtedly opportunity for meaningful gain as clarity is restored. Corporate credit yield premiums are approaching those that occurred during the 2015 energy crisis, and are almost two-thirds the level seen during Great Financial Crisis (GFC). Given the significantly stronger banking system and liquidity conditions since the GFC, we feel corporate spreads are selectively attractive, with a bias towards higher quality issuers and those that are more liquid.

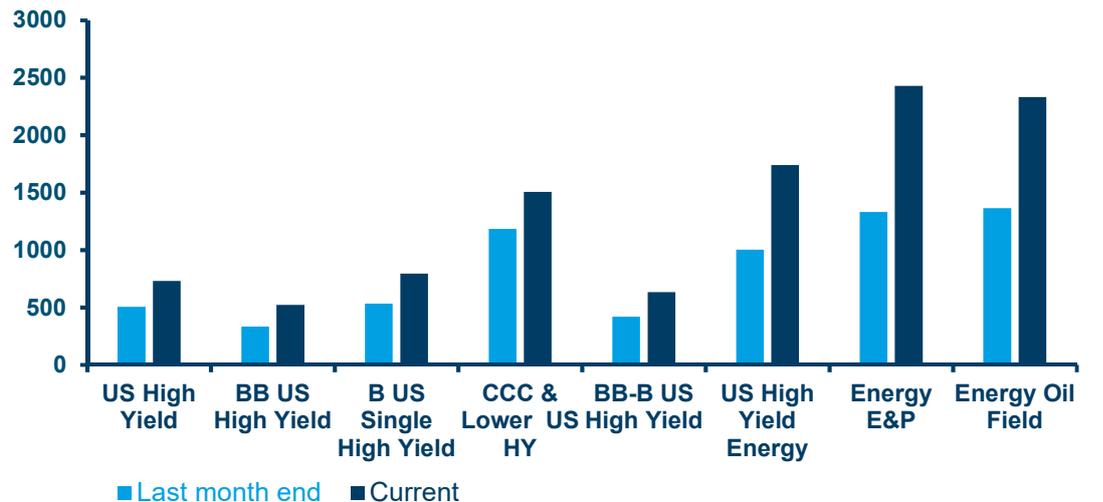
US securitized asset prices have also suffered. **RMBS and ABS offer attractive yield with moderate duration, and agency mortgages strengthen portfolio liquidity at attractive valuations.** Non-agency prime jumbo mortgage-backed securities are a better source of funding for opportunistic purchases.

“We feel corporate spreads are selectively attractive, with a bias towards higher quality issuers and those that are more liquid.”

Corporate and securitized spreads



US High Yield spread (basis points)



Source: Amundi on ICE BofA data, as of 13 March 2020. Each index is a subset of the ICE BofA US HY Index

The March 9 collapse in Treasury yields was unprecedented and reflected a panicked flight to quality. At one point, the entire US yield curve fell below 1% for the first time in history. **Despite the sharp drop, the yield curve remains upward sloping**, therefore not signalling a recession or negative US yields. The Fed's decisive action supports an upward sloping yield curve, and low US Treasury yields do reflect concerns about weak growth and anaemic inflation. **Within the treasury market, 30-year bonds look more attractive than 10-year.** TIPS offer historically low break evens, and bear watching post-Fed weekend action. However, Treasury yields and inflation expectations will likely remain low until there is evidence of the virus' demise and Saudi/Russia compromise on oil.

US Equity: Expect further volatility

We believe equity markets are likely to remain volatile for three reasons:

1. Containment efforts continue to escalate outside of China.

At first, the economic impact of the virus was supply-related as regions of China shut down, limiting the availability of Chinese produced goods. Now, however, the response to the virus is impacting demand globally as people cancel travel plans, meetings, and events, and governments limit movement between and within their countries. This is causing global economic growth to slow.

2. Financial stress is increasing, especially in the oil industry

Slower economic growth, especially a recession, will make it more difficult for corporations to service their debt, which as a percentage of GDP has exceeded its previous peak. Moreover, the percentage of corporate debt that is rated BBB has doubled in the past decade to over 50%. Energy companies are especially at risk given the collapse in oil prices.

3. There is a higher probability that the next president will be a Democrat.

Polling data indicates that the biggest factor influencing voting behavior is the strength of the economy. A Democratic president would likely seek to increase taxes and regulation, both of which would negatively impact corporate profits and equity prices.

Ultimately, the severity of the decline in equities near-term will be tied mostly to how big an impact the coronavirus has on US and global growth. **In our view, the most likely scenario is a prolonged "U"-shaped recovery, in which economic growth declines for at least a couple of quarters and then recovers gradually with the support of accommodative monetary policy and fiscal stimulus such as a payroll tax cut.** Given the difficulty in predicting the depth of the decline and the timing of the recovery, we believe the most **prudent approach is to invest in companies with manageable debt levels, high profit margins, and stable competitive positions.**

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Conclusion

While we acknowledge an increasing likelihood of a global economic contraction, the impact on the US economy could be less severe than other countries or regions. With an expectation that the demand shock from the current public health crisis is temporary, and supply shock of the oil price war will find rational resolution, our outlook is sanguine.

In the meantime, coordinated central bank and government spending will serve to stabilize global growth. We have seen broad-based support for companies and consumers in the form of lower borrowing rates, subsidized lending programs, tax relief, job security and healthcare coverage. In addition, the Fed's extension of liquidity facilities and asset purchase programs serve to strengthen the confidence and operations of financial markets. With central banks pressing on the need to deliver fiscal stimulus, likely coupled with further monetary easing, economic growth is poised to rebound upon the demise of the coronavirus epidemic and after a return to rational oil prices.

It appears that workers are returning to factories in China, and that economic engine is restarting. Similarly, over the coming months, with greater clarity on the duration and severity of the current crisis, US consumers will feel confident again. Pent up demand should ignite a rebound in activity, a recovery of risky assets, and a normalization of flight-to-quality assets. **Until then, it is critical for investors to be patient and courageous, maintaining portfolio liquidity while capitalizing on selective opportunities to add oversold securities.**

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Definitions

- **Asset purchase programme:** A type of monetary policy wherein central banks purchase securities from the market to increase money supply and encourage lending and investment.
- **Basis points:** One basis point is a unit of measure equal to one one-hundredth of one percentage point (0.01%).
- **Breakeven inflation:** Breakeven inflation is the difference between the nominal yield on a fixed-rate investment and the real yield on an inflation-linked investment of similar maturity and credit quality.
- **Credit spread:** Differential between the yield on a credit bond and the Treasury yield. The option-adjusted spread is a measure of the spread adjusted to take into consideration possible embedded options.
- **Quantitative easing (QE):** QE is a monetary policy instrument used by central banks to stimulate the economy by buying financial assets from commercial banks and other financial institutions.
- **Volatility:** A statistical measure of the dispersion of returns for a given security or market index. Usually, the higher the volatility, the riskier the security/market.

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