15 March 2020
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Investment Event

Federal Reserve goes all out

The Fed cut the funds rate by 100bp and committed to at least USD 700bn of asset purchases in the “coming months”

The moves reflect the COVID-19-driven worsening in the economic outlook and a tightening of financial conditions

The Fed’s action follows those from the ECB and Bank of England, which both delivered comprehensive easing packages

Our views

We believe it makes sense to adopt a more neutral tactical view on developed market equities in such a highly uncertain and volatile environment

However, we maintain a strategically pro-risk stance in the context of hugely improved relative valuations for risky assets

Federal Reserve cuts rates and restarts asset purchases

Following an unscheduled meeting over the weekend the US Federal Reserve (Fed) announced on Sunday 15 March that it would cut the target range for the federal funds rate by 100bp to 0-0.25 percent and committed to at least USD 700bn of asset purchases. The asset purchases would be across US Treasuries (at least USD 500bn) and agency mortgage-backed securities (at least USD 200bn). The Fed also announced other measures to support USD liquidity, including:

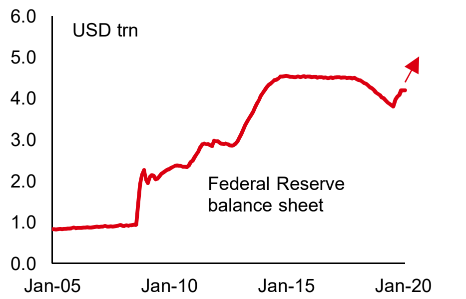
- Reducing the discount window interest rate by 150bp to 0.25%. The discount rate is applied to banks’ borrowing from the Fed
- Coordinated action with the Bank of Canada, the Bank of England, the Bank of Japan, the European Central Bank and the Swiss National Bank to enhance the provision of liquidity via the standing USD liquidity swap line arrangements
- Eliminating the reserve requirement for banks

COVID-19 requires a forceful response

The action follows a significant increase in the cases of coronavirus globally and within the US in recent days and a ramping up of administrative measures aimed at containing the outbreaks. Both the virus and the containment measures are likely to have a significant negative impact on economic activity; in his press conference, Fed Chair Powell mentioned the US and global economy are already seeing a fall in business activity. Financial conditions have also deteriorated with corporate bond spreads widening and equity markets falling sharply.

The Fed statement noted that it expects to maintain the funds rate at 0-0.25bp “until it is confident that the economy has weathered recent events and is on track to achieve its maximum employment and price stability goals”. As Chair Powell noted, it is highly uncertain for how long COVID-19 and the containment measures will impede economic activity.

Figure 1: New high for the balance sheet



Source: Macrobond

The decision to announce large-scale purchases of US Treasuries and agency mortgage-backed securities was a reaction to signs of stress in both markets. The Fed expects asset purchases to support the availability of credit by encouraging proper functioning of these markets. The Fed intends to the make the purchases over the “coming months” at a “strong rate” with no weekly or monthly caps.

The Fed’s action follows those from the ECB and Bank of England, which both delivered comprehensive easing packages. Central banks are acutely aware that policy makers must prevent a medical crisis triggering significant financial stress; recessions associated with high levels of financial stress tend to be deeper, longer and followed by a slower recovery.

Avoiding such outcomes is likely to require the forceful response by central banks to be backed up by large-scale fiscal measures, including public sector guarantees of private sector debt and, potentially, public sector equity injections into key industries. Significant fiscal stimulus is being floated in the US, but as yet the plans lack detail. We are monitoring these developments closely.

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Market considerations

Even with substantial policy easing, the economic outlook is likely to remain unusually uncertain and volatility in markets unusually elevated. Consequently, we believe a more cautious strategy is warranted in the short term. As part of this, we advocate a more neutral tactical view on developed market equities, including US equities (1-3 month view).

However, while the environment is very challenging, there is a silver lining. Recent market moves have incorporated a lot of bad news which has materially increased prospective returns for risky asset classes. The key question for investors is if this price action is in line with the expected deterioration in fundamentals or if emotions have run ahead of themselves and excess pessimism is being embedded in market prices. Although it is difficult to judge this at present, strategically (6-month+) we remain pro-risk, even allowing for higher perceived levels of volatility.

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