18 March 2020
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Investment Event

Policy response gathers pace

Forceful monetary and fiscal policy action is required to support businesses and households

Policy makers are increasingly stepping up to the challenge, with a number of large-scale support packages announced

Economic policy is focused on preventing financial stress; recessions associated with high levels of financial stress tend to be deeper, longer and followed by a slower recovery

Our views

We believe a more neutral tactical view on developed market equities remains warranted 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

HSBC

Stepping up to the challenge

The spread of COVID-19 across the world is a health crisis that threatens to become an economic and financial crisis if monetary and fiscal policy makers do not act in a forceful and innovative way. Importantly, developments and announcements in recent days across major developed economies suggest policy makers are now stepping up to that challenge.

Loan guarantees and increased liquidity

Recent announcements cover a wide range of policies, but perhaps the two most important themes have been: large-scale public sector loans or loan guarantees; and enhanced liquidity provision by central banks.

A number of European governments have committed significant funds to support lending to businesses suffering a "cash-crunch" as a result of administrative measures aimed at slowing the spread of COVID-19. These include:

- Germany's state development bank will grant loans of around EUR 500bn (15% of GDP)
- France will guarantee EUR 300bn (12% of GDP) of bank loans to businesses
- The UK is making available an initial GBP 330bn (15% of GDP) of loan guarantees

These loan guarantees are an important complement to recently-announced central bank liquidity measures. **Offering cheap funding to banks to pass onto firms and households is likely to be more effective if banks are insured against much of the default risk**.

On the monetary side, the US Federal Reserve (Fed) and the Bank of England (BoE) both announced significant new liquidity measures on 17 March 2020:

- The Fed re-introduced a Commercial Paper Funding Facility (CPFF), similar to that created in 2008. **It will purchase highly-rated unsecured and asset-backed commercial paper directly from eligible companies.** The Fed hopes the facility will improve the functioning of the commercial paper market and the flow of credit to businesses and households.
- The Fed also created a Primary Dealer Credit Facility (PDCF). This will offer overnight and term funding (up to 90 days) and will be in place for at least six months. **Primary dealers will be able to use "a broad range of investment grade debt securities, including commercial paper and municipal bonds, and a broad range of equity securities" as collateral**. Even during the global financial crisis the Fed did not lend against equity.
- The BoE will operate (on behalf of the UK Treasury) a new lending scheme for large firms – the Covid Corporate Financing Facility (CCFF). Under this scheme, **the BoE will purchase commercial paper** of up to one-year maturity "on terms comparable to those prevailing in markets in the period before the COVID-19 economic shock" for "firms that can demonstrate they were in sound financial health prior to the shock".

While the spread of COVID-19, the associated administrative measures to slow the spread, and the first-round economic impact are beyond the control of monetary and fiscal policy makers, the actions taken in recent days are important. It is critical that policy makers prevent a health crisis triggering significant financial stress; recessions associated with high levels of financial stress tend to be deeper, longer and followed by a slower recovery.

Markets are now likely to turn their focus to the US government fiscal measures currently under discussion. Press reports suggest the package will be worth USD1-1.2trn (around 5% of GDP) spread across direct cash payments, small business loans, industry support, deferred tax payments, and improved sick leave and unemployment benefits.

Market considerations

Even with substantial policy easing, volatility in markets is likely to remain elevated given the significant negative impact COVID-19 is expected to have on economies. Consequently, we believe a cautious strategy remains warranted in the short term. As part of this, we advocate a more neutral tactical view on developed market equities (1-3 months 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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