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Viewpoint

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ASSET MANAGEMENT | WHITE PAPER

Gallant Steeds or One-Trick Ponies?

The World's Central Banks React to a Pandemic

By Richard L. Sega, FSA, MAAA, Global Chief Investment Strategist

Summary

Central banks globally have intervened in their respective economies to a scale that is truly unprecedented. The immediate impact has been positive in some respects, inconclusive in others. There is great hope for the longer term, but the risks are significant.

"Whatever it takes"

At his April 29 press conference, U.S. Federal Reserve (Fed) chair Jay Powell said: "economic forecasts are always uncertain; today they are unusually uncertain."[1]

Markets hate uncertainty. So they really hate the public health crisis and the damage being caused by the economic lockdowns, and really love the world's central bankers riding in on their white horses with a wide range of ideas to offset the risks. In the U.S., the Fed has taken a number of steps in conjunction with the U.S. Treasury to stabilize financial markets. In the past two months they have introduced a range of programs:

- The Primary Dealer Credit Facility (PDCF)
- The Money Market Mutual Fund Liquidity Facility (MMLF)
- The Commercial Paper Funding Facility (CPFF)
- The Term Asset-Backed Securities Loan Facility (TALF)
- The Municipal Liquidity Facility (MLF)
- The Main Street Lending Program
- Primary Market Corporate Credit Facility (PMCCF)
- Secondary Market Corporate Credit Facility (SMCCF)

Globally, the reaction has been similiar.

Bank of England (BOE)

- The BOE's Monetary Policy Committee (MPC) has reduced its bank rate by 65 basis points and announced an increase in the stock of asset purchases, financed by the issuance of central bank reserves to a total of £645 billion. The MPC added: "If needed, the MPC can expand asset purchases further."
- The Financial Policy Committee (FPC) reduced the UK countercyclical capital buffer rate to 0% of banks' exposures to UK borrowers.
- Their Treasury created the Covid Corporate Financing Facility (CCFF) to provide funding to businesses by purchasing commercial paper of up to a one-year maturity.
- A Term Funding scheme (TFSME) operated through qualifying banks will offer four-year funding at or close to the bank rate (currently 0.1%) with additional incentives for Small and Medium-sized Enterprises.

European Central Bank (ECB)

- With negative rates (deposit facility = -0.50%), the ECB has not cut rates.
- The Pandemic Emergency Purchase Programme (PEPP) increases the existing QE program of up to €750 billion until the end of the year, amounting to 7.3% of euro-area GDP (a German court has ruled this move illegal but that should be resolved soon). Importantly for markets, this was reinforced by the statement: "We are fully prepared to increase the size of our asset purchase programmes and adjust their composition, by as much as necessary and for as long as needed."
- A commercial paper purchase program supports first-line lending to larger businesses, as well as expanding the eligible collateral in the ECB's refinancing operations
- European banking supervisors have also freed up an estimated €120 billion of extra bank capital, which can support considerable lending capacity by euro-area banks.
- Additional longer-term refinancing operations (LTROs) will be conducted, temporarily, to provide immediate liquidity support to the euro-area financial system

People's Bank of China (PBOC)

- Beijing had introduced a raft of support measures such as extended loan terms, forbearance on loan repayment, postponed/cut tax payments, and lower rents.
- The one-year loan prime rate had been cut and is likely to be moved lower.
- PBOC also stipulated that banks need to demonstrate that the net new increase in bank loans for Q1 2020 cannot be lower than the RMB 5.8-trillion increase of Q1 2019, which would result in a minimum annual growth rate of 11.8% in Q1 2020 outstanding bank loans.

Bank of Japan (BOJ)

- After years of fighting slow growth and no inflation, there are not many options left to the BOJ beyond cutting rates further into negative territory.
- The BOJ has started a program to purchase commercial paper and corporate bonds.

QE or not QE?

All of these actions show resolve in the face of the virus's impact. Will it help?

Two of Conning's U.S. credit experts say the Fed's recent action was very helpful in their markets.

Matt Daly, Head of Corporate and Municipal Bond Teams

- Fed response very well received in corporate market:
  - Corporate credit spreads widened starting late February
  - At peak March 23, Fed announced facilities focused on short-term debt
  - Since then, dramatic snap back in spreads
  - Facilities will cover certain "fallen angels," former IG issuers that fell to below IG, valuable given significant growth in BBB-rated corporate debt.

Paul Norris, Head of Structured Products

- Aggressive Fed actions helpful to mortgage, consumer markets
  - Fed began purchasing MBS in late March, helping lower mortgage interest rates
  - Lower rates enabled homeowners to re-finance and reduce mortgage payments
  - The announced restart of TALF will enable consumer issuers (Ford, GM, etc.) to securitize loans currently on balance sheets
  - Securitizing provides cash for companies to finance more consumer purchases.

In truth, all the steps taken by central banks in this and every crisis amount to one thing: printing money. They can call it QE (or not), monetary accommodation, providing liquidity, facilitating lending, or supporting credit creation. In this respect, central banks are one-trick ponies. Whether it's energy crises, stock market crashes, natural disasters, Y2K, terrorist attacks, they do what they can do, which is print money.

This is especially important in the U.S. for several reasons, not the least of which is the huge and growing shortage of U.S. dollars globally. The thirst for dollars arises both from the history of debt financing in emerging markets and from thoroughly disrupted global supply chains. Billions in dollar-denominated debt owed by China as well as Asian and European emerging countries will be coming due in the next few years and will have to be paid off or refinanced. Couple that with the demand of exporting countries to be paid in dollars for the resources needed to rebuild economies and supply chains. It's unlikely that oil or agricultural exporters will accept RMB -- in any major transaction they'll want dollars. The Fed has engaged in extensive foreign-exchange swap programs to help alleviate this, but the demand for dollars will persist.

The Addiction Model

"I used ta do a little but a little wouldn't do
So the little got more and more...
Said a little more than before"
Guns N' Roses - Appetite for Destruction, 1987

There's no doubt that the actions of the world's central banks, in particular those of the Fed, should help markets trade better wherever they intervene. Whether it's high-grade corporate bonds, high-yield bond ETFs, or agency mortgages, central banks are buying or planning to buy assets into government possession because investors who normally would be buying are not, at least not in sufficient numbers, at prices high enough to avoid deflationary pressures that could threaten the stability of their financial systems. These actions, of course, remove some information from the market-place since non-economic buyers like central banks artificially alter prices, which are the signals that tell investors and traders how to allocate capital to risks across the economy.

This feels good for the near term and buys time for other policy measures to take effect, especially fiscal policy. We see this in the behavior of equity markets; while not buying stocks themselves (yet), the Fed has convinced equity investors that they will continue to supply virtually unlimited liquidity to the economy. But a major tenet of pharmacology is that "dose determines toxicity:" just because something is beneficial in small amounts doesn't mean that more is better. This principle applies well to government policies too.

As market analyst Jim Bianco has colorfully alluded, the markets are junkies and the Fed is their pusher. The addiction model is apt.[2] Now up to ~$5.5 trillion, the Fed's balance sheet could go to $10 or $12 trillion, or even higher (Figure 1). Even before the coronavirus crisis, the Bank of International Settlements reported last year that we have "a global economy that has been unable to jettison its debt-dependent growth model." Every round of the boom-bust cycle ratchets up the level of debt and degree of government intervention. We are running a live experiment in "Modern Monetary Theory." Given the unknowns we face, the markets have shown remarkable confidence in the future (Figure 2).

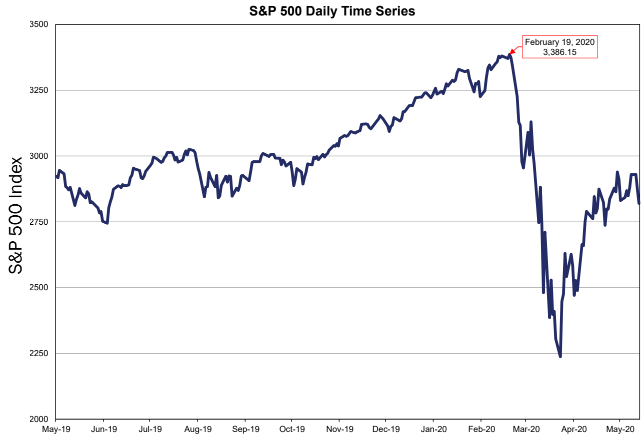
Figure 1 Domestic Securities Holdings (as of May 6, 2020)

Security Type	Total (In Thousands)
US Treasury Bills (T-Bills)	326,044,000
US Treasury Notes and Bonds (Notes/Bonds)	3,393,970,050
US Treasury Floating Rate Notes (FRN)	15,545,746
US Treasury Inflation-Protected Securities (TIPS)*	248,265,919
Federal Agency Securities**	2,347,000
Agency Mortgage-Backed Securities***	1,597,206,156
Agency Commercial Mortgage-Backed Securities ***	8,174,0227
Total SOMA Holdings****	5,591,552,893
Change From Prior Week	49,104,903

*Does not reflect inflation compensation of 36,365,239.3
**Fannie Mae, Freddie Mac and Federal Home Loan Bank
***Guaranteed by Fannie Mae, Freddie Mac, and Ginnie Mae. Current face value of the securities, which is the remaining principal balance of the securities.
**** System Open Market Accounts

Source: Federal Reserve Board of NY, System Open Market Account (SOMA) dated May 6, 2020, https://www.newyorkfed.org/markets/soma/sysopen_accholdings

Figure 2 S&P Performance - 12 Months



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Gallant Steeds by a Nose

The response to a novel virus to which no one has immunity was to shut down the global economy. The damage done by the stress and anguish of lost jobs, savings, and opportunity, along with loved ones fallen victim to this disease, has presented a challenging era to navigate.

The global central banks' responses to the devastating threat from the virus have been swift, thorough, and desperately needed. They are to be commended; they have been the gallant steeds markets have hoped for.

But monetary policy has limitations; it can't cure all evils. Central banks can't cure disease or manufacture ventilators. They can't predict pandemics or public behaviors. They can't overcome the bad fiscal and regulatory policies of their countries' political leadership. And despite all the money they print, they can't produce real economic output and opportunity, the kind that are critical to the quality of lives, health, and well-being of so many suffering people right now. Let's hope the central banks are measured and thoughtful as we proceed through the next phase of the battle against the virus. And let's hope they keep the doses of their cures below toxic levels that could do more harm than good.

Richard L. Sega, FSA, MAAA, is a Managing Director and Global Chief Investment Strategist. He plays an integral role in the formulation of the firm's economic and market views. Previously he served as Conning's Chief Investment Officer, and was responsible for credit research, investment management and trading. Prior to joining Conning in 2000, Mr. Sega was President and Chief Executive Officer of Charter Oak Capital Management, Inc. He earned a degree in mathematics from Fordham University and an MA in statistics from Columbia University. Mr. Sega is a member of the CFA Institute.

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Footnotes

1. Source: Board of Governors of the Federal Reserve System, "Transcript of Chair Powell's Press Conference April 29, 2020," https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20200429.pdf
2. Source: Master in Business with Barry Ritholtz" podcast, Bloomberg Radio, Transcript: Jim Bianco, May 10, 2020, https://ritholtz.com/2020/05/transcript-jim-bianco/

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