Commentary
Markets

15 April 2020

Time to Stop Worrying?
...And Love the Fed?

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This week we take a look at how central banks and policymakers ramped up their response to the ongoing crisis.

Unprecedented was pretty much the word of the week, with the implementation of a set of unprecedented liquidity measures to take on the deleterious effects of a crisis of never-before-known dimensions.

A Triple Shock

The first thing to reiterate is that this is several crises rolled together. It's primarily a medical crisis, which although looking like slowing down is still far from ending.

It's a supply and demand shock driven by the enforced closures of businesses and restrictions on personal mobility.

It's also a liquidity crisis; driven by many investors running for the same exit door at the same time, as well as the threat of a financial crisis.

Obviously, all of these are worrying, but as a market participant it was the drying up of liquidity — even in bellwether markets such as US treasuries — which surprised and alarmed us the most. Some of these fears have abated recently, and that was due to a set of unprecedented liquidity measures provided in a relatively coordinated fashion by central banks globally.

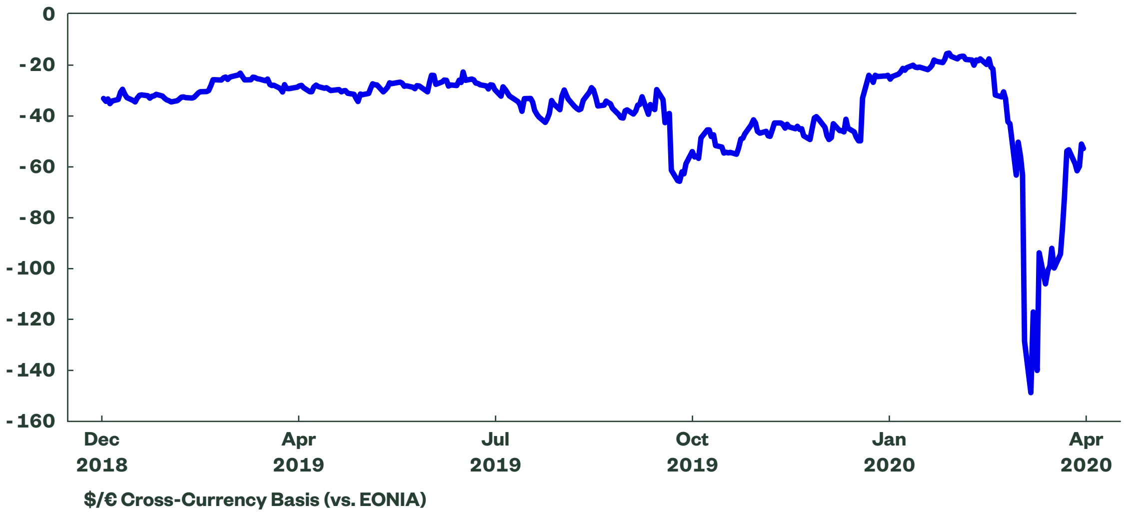
Fed Liquidity Tap Seems to Be Working

To focus first on the US and the Fed, we initially saw a huge drop in the dollar as the Fed, almost preemptively, cut rates ahead of other central banks, which then segued into a spike, as investors looked to liquidate their positions and scrambled for USD cash liquidity as the treasury market dried up temporarily.

In a similar fashion, we saw the cross-currency basis versus the dollar go negative across the board, indicating massive demand by overseas investors to swap their home currencies back to the dollar.

What we see in both these measures of USD funding stress over the last few days, is that they have relented, although the cross-currency basis in particular is not back to the levels it was pre-crisis, so we're not quite out of the woods yet.

Figure 1
Fed Liquidity Tap Seems to be Working



Source: Bloomberg. As at April 2020.

Some Calming but Nowhere Near Pre-Crisis Levels

Another, more direct, way of looking at market stress is through derivative pricing.

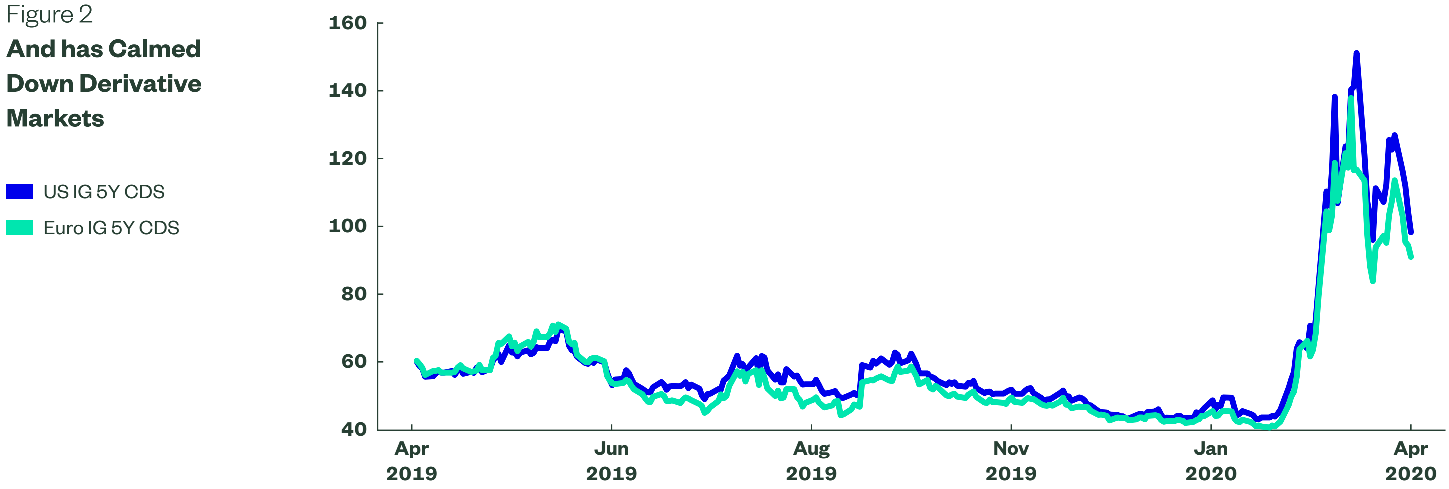
We use our Market Regime Indicator, or MRI, which combines implied volatility measures and risky asset spreads across asset classes to give a reading on the market's view of risk. When we examined three key measures of implied volatility in the foreign exchange, fixed income, and equity markets, and mapped how they have evolved since before the crisis we clearly saw that equity implied volatility, in the form of the VIX, jumped the furthest, and indeed the VIX set a new all-time high, followed by fixed income implieds and then foreign exchange.

We've now seen all three measures calm down, but like the US dollar levels we discussed ealier, and the Credit Default Swap spreads on the chart below, the market is nowhere near where it came from at the beginning of this year.

Policy measures announcements came in swift succession and there was seemingly a will to keep extending and adapting as conditions changed. In comparison, the policy response post the Global Financial Crisis seemed labored and unimaginative.

In other words, the Fed and other central banks have done a great job, but the world still needs a lot of nursing back to health.

Figure 2
And has Calmed Down Derivative Markets



Source: Bloomberg. As at April 2020.

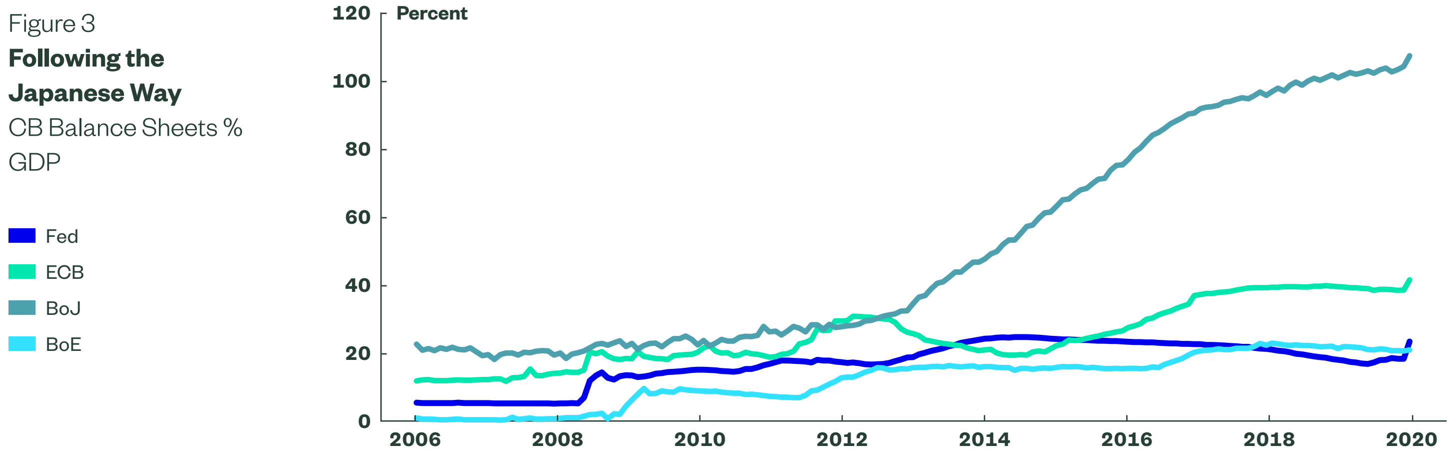
Are We All Japan Now?

So where does this leave us? Well, many commentators have talked about the 'Japanification' of global economies and by one measure — central bank policy rates — we are pretty much there already, with rates converging towards zero, or even below in some cases.

If you look at the size of central bank balance sheets in USD terms, then the Fed and ECB have both more or less converged towards Japan, at around 6 trillion USD.

But, normalizing those levels with respect to GDP shows there is still room to go before a full Japanification, with the Bank of Japan having debt levels pushing well past 100% of GDP, with the ECB a distant second and the Fed and Bank of England some way off in third. So by this measure, there's still some room to go...

Figure 3
Following the Japanese Way
CB Balance Sheets % GDP



Source: Bloomberg. As at April 2020.

Quality, Quality, Quality

And what might rates being lower for longer mean for investments?

Well, what is certainly true is that rate-constrained environments benefit defensive factors, and especially the Quality factor which focuses on low leverage, high return on equity, and low earnings variability.

This means the same defensive sectors which have been outperforming so far will continue to outperform, and we should continue to see a very clear regional demarcation, with the US staying in the lead with its overweight to Quality.

So, in a nutshell, Defensives trump Cyclicals and the US trumps the rest of the world.

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ID196735-3044714.1.1.GBL.INST 0420
Exp. Date: 30/04/2021