March 23, 2020

Weekly Macro & Markets View

Highlights and View

- **Fed and ECB announce large asset purchase programmes while many Asian central banks cut rates**

  Aggressive monetary stimulus will help cushion some of the economic and financial market damage from the COVID-19 outbreak, but the economic contraction will still be substantial.

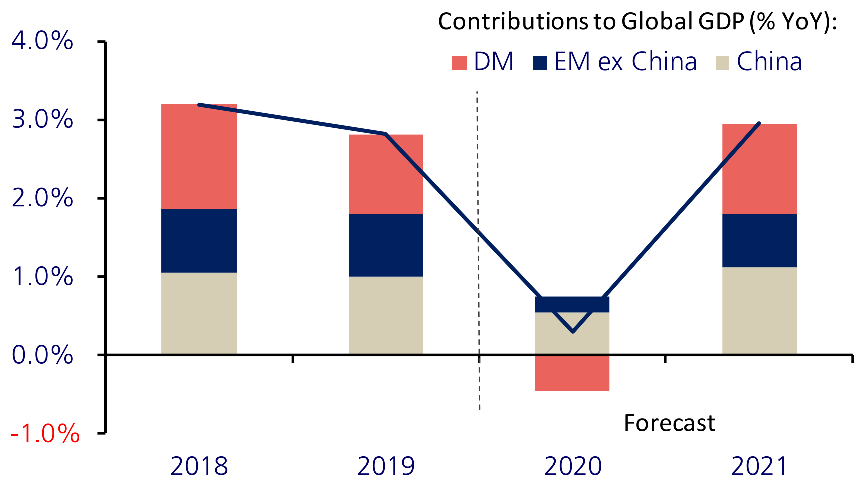
- **Fiscal support is ramping up, but more is needed to support a stalling global economy**

  European governments announced fiscal support and more should follow. We expect the US Congress to pass substantial support eventually but precious time has been wasted.

- **US credit seem to be having a meltdown amid thin liquidity, as outflows hit a record USD 35bn**

  While last week's price action reflects an acknowledgment of weak credit fundamentals, a stabilisation of infections and aggressive policy steps are required for spreads to top out.

Gloom, but not doomed



Source: ZIG, IMF, Consensus, Bloomberg

Last week saw unprecedented events unfold and it became clear that the world is facing a dual health and economic crisis. The virus has tragically claimed more than 13,000 deaths and governments have responded with unheard of measures to curtail infection. We had already expected a mild 2020 recession as the result of an extended economic cycle and economic fragilities. In light of last week's lockdowns, along with the record slump in China's activity in January and February — which was far deeper than expected — it is painstakingly clear that the global economy will be hit hard in 2020. We now expect a deep, but short lived, global recession, where a collapse in global activity in the first half of the year is followed by a recovery, leaving little long-term damage to the global economy. Uncertainty is pervasive, however, and this outlook crucially hinges on positive developments on two fronts: measures to contain the virus eventually prove effective, with economic lockdowns lasting no longer than two months, and sufficient policy measures, including state aid, are put in place to prevent layoffs, defaults, and credit events. Risk is to the downside and the developments in the coming couple of weeks will be critical in determining just how deep and long lasting the recession will be.

Markets: Turmoil is pervasive with volatility at record levels. What needs to change?

Stocks plunged further with the MSCI World index down over 12% on the week, the Eurozone doing better and the US lagging, while credit spreads soared. The fall in equites has been the sharpest on record, with volatility measures on Wednesday surpassing the highs of the financial crisis. During days like these it is best remembered not to panic. That noted, we do expect further downside for both credit and equity markets before confidence begins to rebuild. For us, three things need to happen: monetary policy needs to be profound, unequivocal and well-orchestrated; fiscal initiatives need to be swift and of a scale that is overwhelming; and there must be evidence that the virus is being contained, because it is almost impossible to quantify the impact and value assets until it is. Currently we are about half way there. Monetary policy is doing all it can, but while fiscal stimulus sounds impressive globally, we need to see implementation and soon. As for the virus, we suspect it will be a few more weeks before we see a peak in infections. Consequently, caution is still required despite the prospects of recovery.

COVID-19 Developments: Exponential growth in regions ex-China

Global coronavirus infections are growing at an exponential rate, particularly in many European countries and the US, while cases are also increasing rapidly in Australia and Malaysia. China, where the pandemic first broke out, is out of the limelight, with new cases restricted to a few travellers entering the country, while active cases are now lower than in Switzerland, for example. More people infected by the virus have died in Italy than in China. Several countries in Europe as well as California, New York City and Manila have incorporated partial or full lockdowns, while Australia's famous Bondi Beach has also been closed. In Iran, another country suffering from a heavy death toll, new year celebrations have been cancelled. Borders within Europe as well as those between the US, Canada and Mexico have been closed, while many international flights have been cancelled. Where suitable, companies are switching to home office. Panic buying for daily necessities has been observed in several countries. Overall, it is likely that conditions will deteriorate before any kind of marginal improvement becomes evident.

Monetary Policy Actions: Central banks act swiftly to support market liquidity

The Fed cut its target rate back to its recent lower bound of 0 to 0.25% and announced further asset purchases and several other measures to support market liquidity and the flow of credit. It will purchase an unlimited number of Treasuries and MBS and announced a range of instruments to support the credit market, including a facility to buy corporate bonds in the secondary market. It has also cut the reserve requirement ratio to zero, lowered the credit rate for discount window lending to 25bps, and has agreed to provide dollar liquidity swaps with a range of central banks around the globe. Meanwhile, the ECB announced on Wednesday an increase in QE asset purchases of EUR 750bn, bringing total monthly purchases to more than EUR 100bn. The range of eligible assets was also widened to include commercial paper. The ECB is also considering relaxing self-imposed limits and even increasing the size of the overall programme further if need be. This was the monetary 'bazooka' that markets had been pushing for and will help to stabilise periphery bond spreads.

Fiscal Policy Actions: Stimulus is ramping up, but more is needed

The US Congress's attempt to finalise a USD 2tn stimulus package over the weekend failed as Democrats and Republicans could not agree on some fundamental principles regarding the main beneficiaries of the stimulus. The plan under discussion includes support for small businesses and distressed industries like airlines as well as additional funds for unemployment insurance and healthcare. We expect a stimulus package to pass Congress eventually but with every day that passes without support business and market confidence will suffer, causing irreparable damage to the economy. Eurozone governments have announced spending representing around 1-2% of GDP, including for healthcare and help to pay employees' wages. According to weekend press reports, the German government will also make an exemption to the constitutionally enshrined debt brake clause in order to run a much larger deficit this year. However, even more stimulus is needed. The activation of the European Stability Mechanism with EUR 400bn (around 3% of GDP) of spending power at its disposal would help.

Credit: US credit melts down as investors rush to the exit

The US credit market seemed to melt down last week amid thin liquidity, as spreads gapped out and outflows hit a record. Bloomberg US corporate investment grade index spreads widened by 147bps on the week to 363bps, a level wider than at any time except the financial crisis. Liquidity has dropped, as partly reflected in the Libor-OIS spread, which continued to widen despite Fed actions. Senior AAA CLO spreads also nearly doubled in a day, while high yield spreads widened by nearly 300bps. US investment grade credit, a bastion of strength for flows so far, saw an outflow of USD 35bn, which smashed the previous week's record outflow of USD 7bn. European spreads fared better but were still significantly wider, while some issuers returned to the primary market, albeit at high concessions. CDS spreads have so far been under reacting but should widen further as liquidation gives way to demand for protection. After the ECB's corporate bond buying, the Fed has also followed. However, given weak fundamentals, a stabilisation of infections and bold fiscal policy are needed for the market to bottom.

What to Watch

- The G3 flash PMIs will reveal to what extent economic activity collapsed in March.
- In the Eurozone, business and consumer sentiment data, which is very likely to be weak, will be released and finance ministers at the Eurogroup meeting on Monday and Tuesday could announce the activation of the EUR 400bn ESM fund.
- In Asia, following a week full of policy rate cuts, we will keep an eye on industrial production data for February in Taiwan, Thailand and Singapore. In Japan, department store sales for February and Tokyo's CPI for March will be in focus. In Australia, the CBA PMIs for March will be released.

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