Manulife Investment Management

Market Note

23 Mar 2020

It's been a rocky week for financial markets, as investors react to policymakers' response to limit the economic impact of the coronavirus outbreak. While much of the media's coverage has focused on the number of infections and the market reaction, our Global Chief Economist Frances Donald believes it's just as important for investors to keep an eye on one area: the fixed-income space.

From coronavirus to credit market stress

It's clear to us that the global economy is experiencing the beginnings of one of the sharpest contractions in modern economic history. As unsettling as that thought is, it's crucial that we shift some of our attention from the cause of the contraction and start focusing on a troubling side effect: the dysfunction in the global fixed-income market. In our view, it's critical that central banks worldwide are able to act to prevent this market from experiencing further stress, or the upcoming economic downturn will be prolonged and worsened. From an investment perspective, this could also mean that the risk-off mentality will likely persist for a much longer period of time.

There's no doubt that the rate at which the COVID-19 infection grows—or falls—is important, but so are fiscal measures—they'll influence the depth of the recession and the timing and shape of the recovery. But the pressing macroeconomic question at hand, in our view, has less to do with the viral outbreak and more to do with restoring calm to the credit markets.

On this front, there's some *positive* news. In addition to the U.S. Federal Reserve's (Fed's) giant stimulus package unveiled on 15 March[1] and its follow-up announcement regarding the Commercial Paper Funding Facility (CPFF) two days later,[2] in the past 48 hours (as of 20 Mar), the Fed has also:

- **Implemented the MMLF.**[3] In an effort to unfreeze the commercial paper market, the Fed's Money Market Mutual Fund Liquidity Facility (MMLF) provides nonrecourse funding (i.e., funding secured by collateral) for banks and broker-dealers to buy commercial papers that money market funds are trying to sell. The Fed allowed banks to exclude these transactions from the way bank capital is usually calculated so that banks using this facility don't end up using precious balance sheet space (in the form of reduced capital buffer). This is an important distinction between the MMLF and the CPFF.

- **Expanded its U.S. dollar (USD) swap lines.** The facility has been expanded to include additional central banks.[4] Crucially, the Fed announced on March 20 that the swap lines would run on a daily, not weekly, basis.
- **Continued QE at a blazing pace.** The Fed will buy US$275 billion of Treasuries during the week of 16 March[5] and we think it's very likely that it will have to further expand its quantitative easing (QE) program, initially described as "at least US$500 billion,"[1] fairly soon.

[1] "FOMC Press Conference Call," federalreserve.gov, 15 March 2020.

[2] "Commercial Paper Funding Facility (CPFF)," federalreserve.gov, 18 March 2020.
[3] "Federal bank regulatory agencies issue interim final rule for Money Market Liquidity Facility," federalreserve.gov, 19 March 2020.
[4] "Coordinated central bank action to further enhance the provision of U.S. dollar liquidity," federalreserve.gov, 20 March 2020.
[5] Bloomberg, 16 March 2020.

Over in Europe, the European Central Bank also unveiled a massive stimulus package on Wednesday, announcing that it will take much more periphery debt, private sector commercial paper, and corporate debt onto its balance sheet.[6]

Let's be clear—these are very important policy actions that have managed to calm the U.S. Treasury markets to a degree. However, we believe there are sizable and pressing problems at play and, until these issues are addressed, it makes sense to remain cautious.

Problems that still need addressing

1) **Real yields are rising (defined as nominal yields minus inflation), as market-based measures of inflation continue to plummet.** Dramatically lower oil prices aren't helping. As a senior colleague observed, real yields are typically the single most important measure of whether the market believes the Fed will be successful at bolstering inflation. In our view, the Fed is likely to be monitoring real yields very closely.
2) **Swap lines could be more inclusive.** While the Fed's expanded swap lines will no doubt ease concerns about a potential shortage in the USD, the arrangement excludes India and China, which could limit the effectiveness of the program. As a result, we're likely to see continued upward pressure on the USD, although to a lesser extent.
3) **Mortgage rates are rising.** This is likely to put a cap on the surge in refinancing applications that we saw earlier this month. This counterintuitive development speaks to the weak transmission mechanism between the Fed's rate cuts and the real economy, and the inefficiencies of cutting rates when banks are worried about extending loans to consumers whose financial circumstances could change soon.
4) **There are still sizable discounts between the prices of ETFs and their underlying net asset values.** This is particularly true for fixed-income exchange-traded funds (ETFs), suggesting there could be stress within that market.
5) **Municipal bonds are also displaying signs of stress.** As another colleague noted, many U.S. municipalities typically rely on sales tax, income tax, and corporate tax revenues to operate. As economic activities stall, it's likely many of them will see reduced revenues, which would have implications for this market segment.

Conclusion

It's an indisputable fact: Central banks have been hard at work this week, digging deep into their respective toolboxes to limit the extent of the economic damage. In our opinion, while we're grateful that they've done as much within such a short period of time, there can be no doubt that more impactful policy actions will be needed.

[6] "ECB announces €750 billion Pandemic Emergency Purchase Programme (PEPP)," European Central Bank, 18 March 2020.

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