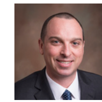
Strong Fiscal Response Needed After Fed Moves on Liquidity

Investors fear central banks have reached the limit of their influence.

March 2020



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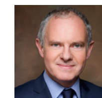
Lead Portfolio Manager, New Income Fund



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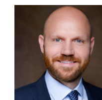
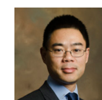


Nikolaj Schmidt
Chief International Economist



Ju Yen Tan
Senior Portfolio Manager, Global Fixed Income

KEY INSIGHTS

- Bold central bank actions have failed to prevent steep declines in equity markets and weakness in credit markets, indicating investor concern that not enough is being done.
- Central banks have moved aggressively to address liquidity issues, but governments need to produce an effective fiscal response.
- For stability to return, there needs to be clear evidence that countries that have taken Draconian measures are succeeding and that others are on the right path.

Aggressive global central bank moves to blunt the financial impact of the coronavirus outbreak have failed to reassure equity and credit markets, putting pressure on governments to come up with a more emphatic fiscal response to the crisis.

While the actions from the U.S. Federal Reserve (Fed) and other central banks were bold, they were not enough to offset the onslaught of bad news surrounding the outbreak, providing further evidence that there is a limit to what central banks can achieve alone. Proof that some countries are succeeding in tackling the coronavirus, providing a clear pathway to those behind the curve, likely will be needed for stability to return to the markets. In the meantime, while negative U.S. policy rates remain unlikely, it is possible that Treasury yields may fall below zero if investor demand for safe-haven assets remains strong.

What Has Happened Over the Past Few Days?

The Fed's decision on Sunday, March 15, to slash its main policy rate by 100 basis points (bps) and announce at least USD 700 billion in asset purchases was followed on Monday by the Bank of Japan's announcement that it aimed to double its purchases of exchange-traded funds to JPY 12 trillion.

Despite these moves, which were without parallel since the global financial crisis, stock markets suffered heavy losses on Monday morning following a weekend of worsening news over the coronavirus. This implies that investors fear that central bank support is close to being exhausted and that a robust fiscal response to the demand shock remains elusive.

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>
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> *Chief International Economist*

The Fed's announcement can be summarized as follows:

- Policymakers cut the federal funds rate by 100 bps. Following the 50-bps cut on March 3, this takes the policy rate to the zero lower bound, targeting the 0.25 bps range not seen since 2015.
- The central bank announced at least USD 700 billion of open-ended asset purchases in the form of USD 500 billion of Treasuries and USD 200 billion of agency mortgage-backed securities, indicating no nominal amount or time limit.
- The discount window rate has been reduced by 150 bps to 25 bps, and banks will be allowed to borrow from the discount window for up to 90 days. In the past, banks would often only borrow from the discount window when under financial stress. As such, the Fed also took measures to try to remove the negative stigma of drawing on this borrowing facility. While we are digesting the details of this announcement, on our initial read, the 90-day feature could have important positive implications for the bank funding of America's small businesses. This is critical as small businesses will likely face the most economic pain from the societal measures needed to better contain the coronavirus.
- The Fed reduced the reserve requirement ratio to 0% to help support the credit needs of households and businesses.
- The Fed also reached an agreement with the five other major global central banks (euro area, Japan, Canada, UK, and Switzerland) to enhance the terms of a standing swap line facility. This facility, which had its origins in the 2008 global financial crisis, allows for the borrowing of U.S. dollars in non-U.S. currencies to support the international supply of dollars. In amending the terms, the officials agreed to reduce the pricing of these swap lines by 25 bps and increase the length of these facilities from seven days to 84 days.

Elsewhere, the Bank of Japan temporarily doubled its annual target for equity purchases to JPY 12 trillion (USD 112 billion). The Reserve Bank of New Zealand cut its main policy rate by 75 bps to 0.25%, and the Bank of Canada cut its benchmark lending rate 50 bps to 0.75%.

Why Have Central Banks Taken Such Dramatic Measures?

Broadly, central banks are responding to a massive surge in demand for cash from market participants. Responding to fluctuations in money demand is the fundamental reason we have central banks, and that is why they are taking action now.

More specifically, the Fed probably felt compelled to act over the weekend for two main reasons:

1. Demand destruction from the coronavirus outbreak, combined with plummeting crude oil prices, has upended the growth recovery scenario and made a recession in the first half of 2020 increasingly likely.

2. Bond market liquidity, including in credit and Treasury markets, has been extremely challenged in recent weeks. Commercial paper, which is unsecured debt issued by companies to fund short-term obligations, has also been facing a liquidity squeeze. The implementation of work location contingency plans across many trading desks has not helped the efficient functioning of markets. However, constrained liquidity has been exacerbated by post-2008 financial crisis regulations that dramatically increased bank capital requirements, discouraging or even preventing securities dealers from holding risk assets on their balance sheets. Such measures have even put a strain on trading activity in the Treasury market,

particularly impacting the liquidity of off-the-run (not the most recently issued for a given benchmark maturity) Treasury securities.

What Has Been the Market Reaction?

The central banks' actions were not enough to offset the impact of the bad news emerging over the weekend. Europe is effectively shutting down (which the markets are taking as a signal that the U.S. will follow), and China unveiled a rash of much weaker-than-expected data. Treasury markets responded positively to the central bank moves, benefiting from safe-haven demand as equities plummet. This contrasted with some days in the week of March 9, when U.S. Treasuries sold off in parallel with stocks—an unusual situation. Treasury yields across the curve decreased as investors responded to the cut. (Bond prices and yields move in opposite directions.)

Why Did the Markets Not Respond Positively to the Fed's Move?

The steep declines in equity markets that followed the central bank moves over the weekend indicate that investors fear that central banks have almost reached the limit of what they can meaningfully do to support markets during this crisis. The Fed's actions over the weekend were bold and may go far toward ensuring that money markets do not break down (which would be a calamity). The true impact of the Fed's actions will become apparent in the coming days and weeks.

However, the bottom line is that, because this is a health crisis, there are limits to what monetary policy can do to alleviate it. Central bank actions to loosen financial conditions and address market dislocations are necessary, but not in themselves sufficient, to persuade investors to embrace risk assets at this point in time. Banks cannot keep economies afloat by themselves.

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This means that it now ultimately falls to governments to provide a convincing fiscal response if market volatility is to be assuaged. Even fiscal policy may not be able to achieve much in the near term other than limiting the financial damage to corporations or households during this enforced period of economic hibernation. While this is obviously important, it may not calm markets immediately as fiscal measures tend to have low multiplier effects.

What Will It Take for Stability to Return in the Near Term?

Two things would help:

1. Convincing evidence from regions that have adopted the most Draconian measures to contain the spread of the coronavirus that their approaches are working and the number of new cases has been brought under control.

2. Evidence that sufficient measures are being implemented in locations that are further behind on the infection curve (for example, the U.S.), providing confidence that there is a clear path toward control of the virus.

Will We See Negative Policy Rates in the U.S.?

We believe that a negative fed funds rate is unlikely. The Fed continues to reiterate its aversion to negative rates, saying that they have not been successful in stimulating growth or inflation in the eurozone or Japan. Additionally, negative rates would likely inhibit the U.S. money markets, which are far more critical to the successful functioning of the U.S. economy than money markets and economies in other parts of the world.

However, U.S. Treasury yields could move below zero if demand for safe-haven assets remains very strong.

What Happens Next?

A major challenge at the moment is the high level of uncertainty over the life cycle and behavior of the virus itself and how this will impact individual and corporate risk tolerance. At present, monetary solutions rank lower than health solutions, meaning that any central bank action can only limit damage in the economic sphere. The Fed delivered over the weekend, but there is a limit to what it can do.

The outcome for economies very much depends on the extent to which government safety nets can take over from central banks and underwrite huge swaths of private sector risk. The consequences of this for public sector finances are obvious and may well ultimately herald the true end of a 40-year bull market for government bonds. However, at the moment it is certainly too early to tell, and investors will likely continue to prize liquidity and capital preservation with a keenness not seen since the global financial crisis.

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