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Rubrics Fixed Income Update

16th March 2020

Market Volatility – Policy Response

Central Banking

Every market top is almost always associated with some great sound bites. In 1929, one of America genuinely great economists Irving Fisher famously predicted that stock prices had "reached what looks like a permanently high plateau – his reputation never recovered. In late 2007 Citigroup's Chuck Prince told a reporter "as long as the music is playing, you've got to get up and dance" – the music had already stopped. Just a few short weeks ago Ray Dalio proclaimed that "cash is trash". The expression that was born out of the recent market rally that most incapsulated the times for me was FOMO – "fear of missing out". As with the 2008 crisis Central Banks have their figure prints all over the dislocation the capital markets are going to face in the coming months.

I am of course not suggesting that central banks are at all responsible for the Covid-19 virus or the oil price war set out by Saudi Arabia and Russia. What I am saying is that by trying to manage every ebb and flow of the economy over the last decade with increasingly intrusive and ineffective policy moves, they have encouraged investor behaviour which was reckless at best, irresponsible at worst. We have just hit another iceberg, we are starting to take on some serious amounts of water and we don't seem to have nearly enough life boats left – many of them have been thrown overboard needlessly without any real hope of achieving a solution.

Government policies post 2008 in no way helped address the structural changes affecting the global economy. A lot of monetary firepower was wasted because of poor and ill-advised government policies. It must be said central banks for the most part allowed this reckless behaviour by facilitating it. Their monetary approach meant ultimately more inequality which in turn meant worse political outcomes. Every time I heard US Senators tell the Federal Reserve governors, you're the "only game in town" my heart sank – why didn't anyone at the central banks explain to the politicians they were the "only game in town".

What should not be underestimated today however is that central banks have the power to add ample liquidity to the markets. This is what central banking was designed to do. This is exactly why JP Morgan demanded the reopening over the US central bank post the 1907 Knickerbocker Crisis. During that episode, the New York banking system collapsed due to the failure of the Knickerbocker bank. Ultimately JP Morgan bluffed the market by purporting to enough cash to hold the system together (he didn't), it worked, and confidence eventually recovered. JP Morgan understood why we needed central banks as the whole banking system stared into the abyss. Central banks in times of crises such as these have the ability to flood the market with cash - and that is exactly what they have started to do now. They cannot turn poor businesses into good ones, but they can provide the liquidity required to keep these businesses going – it's then up to the market to decide the value of these businesses or indeed if they are needed at all.

Market Reaction to Policy Intervention

Why has the reaction to central banks been so muted so far? There are several reasons for this.

- Monetary policy is poor at dealing with supply side shocks – lowering interest rates can't get people back to work during a pandemic
- Central bank announcements have thus far been presented in an uncoordinated manner
- Each emergency announcement communicates more about the challenges we face than the solutions they are presenting
- Concerns that central banks have inadequate firepower with rates already at rock bottom
- Each announcement serves as yet another reminder that what is really required is large scale fiscal intervention
- Money printing will not stop the spread of the virus and its hit on the broader economy
- The dramatic unwinding of specific investment strategies like risk-parity and passives
- Central bank policy cannot increase banks' capacity to provide two-way pricing in the post GFC regulatory world

The list could go on but the overriding feeling with market commentators is that central bank policy is failing and in many ways it is. One could argue right now it is adding more fear than reassurance. This we understand. However, over the next 10 days trillions of dollars will come flooding into the markets. This won't change the economic impact of the virus which will be considerable, potentially more severe than 2008, but the panic or "dash for cash" should start to subside. This does not mean we will not see a continuation in the liquidation of certain risk from portfolios. As volatility subsides, we can get better price transparency, and tighter bid-offer spreads and two-way trading activity. This does not mean we have hit the bottom in the markets, but better-quality assets should start to outperform over leverage business models.

The Covid-19 problem will be with us for a while to come. The increased urgency we are seeing from politicians over the weekend, even from the White House, bodes well. Drastic measures taken might look difficult now but in the long run will be well worth it. It is clear from "Sky News" the UK government will have to change course soon and take some control back of the situation. We fully expect some of the news flow out of the US and UK over the coming week will worsen and increasingly resemble what we have been seeing in Italy. Financial markets are preparing for this and are currently pricing in some dire outcomes. On the positive side buying the bottom always makes a lot more sense to me than buying the top.

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March 2020

Emergency Federal Reserve Actions – Sunday March 15th

On Sunday 15th March the Federal Reserve released an unscheduled FOMC statement to address the economic impact of the coronavirus pandemic.

- The FOMC lowered the target rate for Fed funds to 0.00%-0.25%, a cut of 100bp.
- The FOMC intends to maintain this Fed funds target range until the economy has weathered the impact of the coronavirus and is on track to achieve its maximum employment and price stability goals.
- To support the smooth functioning of markets for treasuries and mortgage-backed securities, the FOMC will increase its holdings of treasuries by at least $500bn and mortgage-back securities by at least $200bn over the coming months.
- The Federal Reserve had already expanded its overnight and term repo operations.

The Federal Reserve has taken a number of additional actions to support the flow of credit to households and businesses:

- The use of the discount window to meet liquidity requirements is being encouraged. The Federal Reserve has lowered the primary credit rate by 150bp to 0.25%, incorporating the 100bp Fed fund cut and a 50bp reduction in the additional cost of the primary credit rate.
- The period for which banks can borrow from the discount window has been extended to 90 days.
- The Federal Reserve is encouraging banks to use intraday credit extended by the Federal Reserve.
- The Federal Reserve is encouraging banks to use their capital and liquidity buffers to support lending to households and businesses.
- The Federal Reserve has reduced reserve requirements to zero percent from the next reserve maintenance period.

There has also been coordinated central bank action to support USD liquidity provision.

- Six central banks (The Bank of Canada, the Bank of England, the Bank of Japan, the European Central Bank, the Federal Reserve, and the Swiss National Bank) have announced a lowering of the price of standing USD liquidity swaps by 25bp, meaning the new rate will be OIS+25bp.
- New USD liquidity operations with an 84-day maturity will be offered in addition to the current 1-week maturity operations.

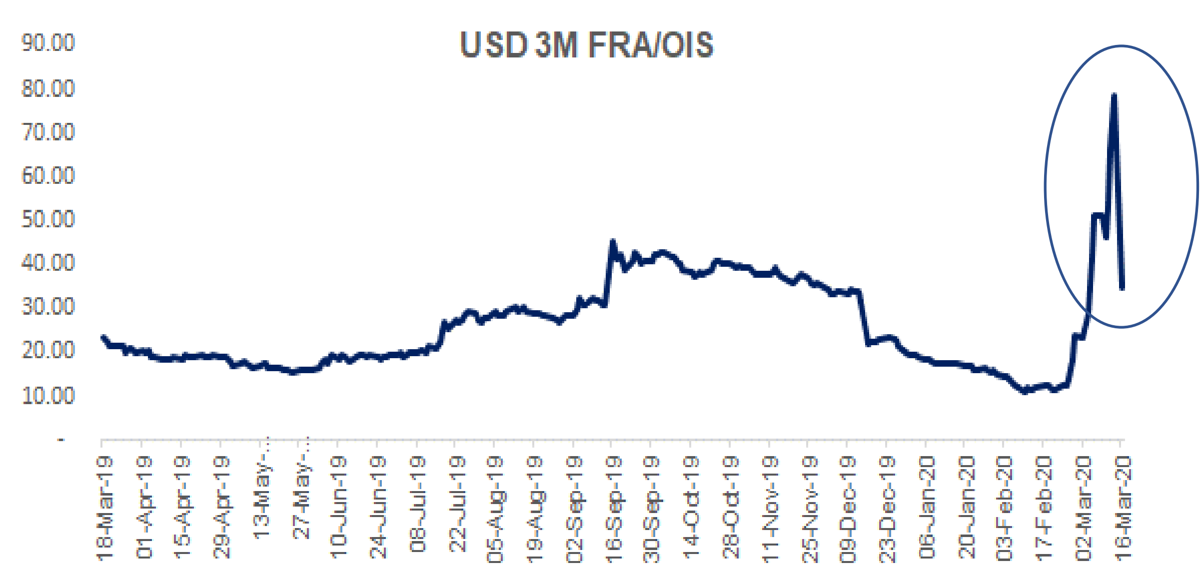
As a result of the above we have seen an easing in liquidity conditions over the past couple of days. Following on from what we mentioned in our piece on Friday, dealers submitted only $18.45BN in securities to today's massive repo operation, down from $24.1BN on Friday, suggesting that the liquidity clogs may be easing somewhat, allied to the easing of conditions in the USD interbank funding market.

Fed Daily Repo Operation

Deal Date: **Monday, March 16, 2020**
Delivery Date: **Monday, March 16, 2020**
Maturity Date: **Tuesday, March 17, 2020**
Type of Operation: **Repo**
Auction Method: **Multiple Price**
Settlement: **Same Day**
Term of Operation - Calendar Days : **1 Day**
Term of Operation - Business Days : **1 Day**
Operation Close Time: **08:45 AM**

Results	Amount ($B)		Rate (%)			
Collateral Type	Submitted	Accepted	Stop-Out[1]	Weighted Average[2]	High	Low
Treasury	86.750	86.750	0.10	0.107	0.15	0.10
Agency	.850	.850	0.10	0.114	0.12	0.10
Mortgage-backed	42.000	42.000	0.10	0.112	0.20	0.10
Total	**129.600**	**129.600**				

Conditions in the USD Interbank Market



Source: Bloomberg, Federal Reserve

IMPORTANT INFORMATION

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