FLASH UPDATE

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Monetary Machinations Continue

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A QUICK UPDATE ON OUR KEY MARKET/MACRO VIEWS:

- A severe, short-lived recession is now highly likely. We expect U.S. GDP to contract at an annual rate of 5% in Q2, with downside risk to our forecast.
- Modeling a pandemic-driven downturn is difficult. The numbers are highly speculative and subject to change. However, data from OpenTable, for example, shows restaurant bookings in the U.S. down 50% year-over-year as of March 15. We expect to see a similar "sudden-stop" across a large portion of discretionary spending in the second quarter.
- The situation is not hopeless though. The examples of China and South Korea show that while a severe decline in economic activity is needed to halt the virus's advance, economic activity will recover once the virus subsides. We are already seeing a rebound in activity in Asia. We expect a similar rebound in the U.S. and Europe in the second half of the year.
- That said, in light of the economic uncertainty, financial market conditions remain challenging, with limited liquidity, heightened volatility, and low trading volume due to limited dealer balance sheets. We are seeing the commercial paper and mortgage-backed securities markets being particularly affected, as well as sharply wider credit spreads across sectors. Since we do think the economy will recover over the longer run, we think it's possible that some of the more extreme market moves reflect a liquidity drought. However, we acknowledge that in the midst of a panic, with the possible economic outcomes wide open, it is difficult to pin down fundamental value.
- In response, the Federal Reserve has unleashed a barrage of liquidity and monetary measures (rates cut to zero, QE4, reserve requirements cut, easing capital requirements, swap lines with global central banks). Of course, the central bank can't solve a pandemic, but it can cushion the financial system and economy from the fallout by supporting the banking system and ensuring healthy market function. We think the Fed could invoke additional emergency lending facilities in the coming days aimed at fixing specific dislocations in financial markets (like the commercial paper market, see below).
- But how do we "fill in the void" left by a sudden-stop in economic activity? Fiscal measures are working their way through Congress that could help direct money to affected sectors, from households to small businesses to major industries. During the 2008 financial crisis, some policymakers worried about the moral hazard of "bailing out" bad actors. No such stigma exists with the public health catastrophe now unfolding worldwide, which should open the door to bold monetary and fiscal actions. Think big! A fiscal package in excess of $1 trillion is in order given the circumstances.
- The Fed has indeed set up a Special Purpose Vehicle, the Commercial Paper Funding Facility 2020 (CPFF2020) via an emergency lending authority, Section 13(3) established in 1932 during the Great Depression to help the Fed route credit to businesses and households more directly. How it works: the Fed creates the special purposes vehicle, CPFF2020. The Fed then lends to the CPFF2020. The CPFF2020 buys CP. The U.S. Treasury will provide credit protection (in the case of actual losses).
- Why is this step so important? Under the 13(3) clause the Fed can effectively lend to markets BEYOND just buying Treasuries and agency MBS. In this way, the Fed can act as "dealer of last resort," effectively replacing the dealers who are unwilling/unable to play the role. Great news for liquidity in the financial system.

Bottom-line: We understand that investors care most about preservation of capital and, while market liquidity may ebb and flow over time, it's important for you to know that your portfolio holdings are under constant surveillance and of sound quality despite current market liquidity conditions. We are confident that the Fed's recent steps to address market liquidity as well as impending fiscal policy actions will ultimately help to "normalize" market conditions.

We will, of course, keep you updated on these very fluid market conditions.