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Coronavirus Update

March 17, 2020

During the first two weeks in March, the coronavirus epidemic exploded onto Europe and the U.S. Initial efforts to contain the virus proved ineffective leading both regions into draconian, growth destroying actions to slow the spread. Financial markets went through two volatile weeks during which equity markets oscillated in more than 10% ranges and interest rates declined to record levels. By Friday, March 13, 2020, sectors critical to the proper functioning of financial markets began to break down. Following an emergency meeting on Sunday, March 15, the Federal Reserve took extreme action lowering the Fed Funds rate by 100 basis points to zero and introducing a new quantitative easing program that targets U.S. treasuries and agency mortgages. Despite this, the equity market cratered again yesterday. Are we entering a new 2008 style crisis?

The Federal Reserve's Actions

On the Fed's actions, the Fed moved preemptively and aggressively upon recognizing two key matters:

1. Financial markets began to break down due to the evaporation of liquidity;
2. The impact of the coronavirus crisis is deeper and more damaging than originally expected.

During March, many unexpected, and generally uncommon, factors came together simultaneously. Led by the required isolation needed to contain the virus, companies moved aggressively to harness their cash and prepare themselves for a period of business contraction. The equity market's volatility swept margined positions, and banks had to fund sizeable draws on credit lines. Also, foreign investors had plowed billions into short to intermediate credit funds and they began to withdraw assets. Altogether, these individually logical actions caused tremendous illiquidity in short-term funds that extend broadly across financial markets. By the middle of last week, short-term credit spreads widened, commercial paper markets shut down and bid/offer prices in the U.S. treasury market were quoted at the widest levels in a decade. Remarkably, a few non-primary dealers refused to make markets in some treasury securities because they could not properly identify prices.

The Fed's actions recognized these stresses and the likely economic damage from dealing with the virus. Their immediate goal is to restore the proper functioning of the treasury market and then, by extension, to ensure there is enough liquidity for the system to function smoothly. With bank liquidity called on to address client cash needs, the banks' intermediary role in financial markets is vastly diminished. Withdrawals from equity funds, high yield funds, corporate cash funds and other riskier assets with no natural buyers causes the chaos credit markets are currently experiencing. The Fed's recognition of these market dynamics is welcome and helpful.

Two logical questions ensue: Is the Fed now "all in?" and what happens when the health threat eases? On the first, no, the Fed has more it can do. In fact, today they announced support for the commercial paper market, a key source of liquidity for many corporations. A concern however, is the effectiveness of monetary policy to address the core problem. Specifically, the economic issue is a forced demand destruction event. The Fed can only address demand indirectly by incenting borrowing to create demand. Consumers will not likely increase "demand" while in quarantine. The demand stall needs a fiscal response, which is likely coming. The second question is more complicated and perhaps meaningful once the virus is reliably contained. History shows stimulus is easier to introduce than to withdraw. When appropriate, the Fed will likely cease additional QE, and slowly restore a more appropriate level for the Fed Funds rate.

The Virus and the Economy

Like other countries confronting the coronavirus, the U.S. believed it could keep the illness from arriving and/or becoming a meaningful health hazard. As Italy, Spain, South Korea and other countries quickly found out, the illness is virulent and highly contagious. Still, upon taking action, countries have witnessed a reliable pattern of contagion, containment and recovery. The U.S. appears to be in the third week of this process, which seems to last four to five weeks until it peaks. After concerted national action to combat the virus, it is likely the U.S. cycle will look similar to that of the more successful countries.

The virtual shut-down of the economy will have dire short-term consequences. Economists already lowered their GDP forecasts with many expecting annualized declines of 5% or worse in the second quarter. Most still expect a meaningful recovery in the second half of the year. Critically, as we navigate the current crisis, conditions in the U.S. economy were meaningfully different this year compared to 2008 when destabilizing events hit. Most notably, consumers, corporations and banks were not overly levered, and the global economy was on an upward trajectory. Unlike 2008, we do not believe the markets' disruptions are a harbinger of a deepening recession. Furthermore, we do not consider the Fed's actions this time to be a bail out. Rather, they are an acknowledgment that an otherwise healthy financial system became stressed by outside factors that the system's participants neither created nor abetted.

Financial Markets

Financial market activity has been extreme and magnified by factors unrelated to the underlying cause of the correction. If the virus runs the expected course, we believe the new valuations offer many attractive opportunities. In fixed income markets, credit sectors sold off to provide liquidity. Dire expectations for defaults and downgrades may also prove excessive.

As in prior episodes of liquidity-driven dislocation, we continue to focus on opportunities to upgrade our holdings and take advantage of market dislocations.

GIA Partners, LLC

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We have a thorough understanding of fixed income investments and their role in a globally diversified portfolio, which has rewarded our clients throughout market cycles.

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