



MORNING BRIEFING

April 8, 2020

The Great Rebalancing: No Asset Left Behind

Check out the accompanying [chart collection](#).

(1) Working on Chapter 13 of the second edition of my Fed book. (2) A work in progress. (3) The Fed's remarkable pivot on March 23 marks end of B-GVC, beginning of A-GVC. (4) Weekly data confirm dash for cash during March. (5) Credit spreads confirm March 23 was a major turning point on the financial front of war against the virus. (6) The Fed is the buyer of last resort for bonds, providing cash for rebalancing into stocks. (7) The Fed's balance sheet is vaulting to new record highs. (8) ECB joins Fed and BOJ with no-asset-left-behind PEPP (Pandemic Emergency Purchase Programme). (9) BOJ doing much more of the same.

Strategy I: Before QE4ever. I published my book [Fed Watching for Fun & Profit](#) in early March. It covers the history of the Fed's policymaking through 2019, focusing particularly on the Fed chairs from Paul Volcker (who led the Fed from August 1979 through August 1987) to Jerome Powell (February 2018-present). I am already working on adding "Chapter 13: The Great Virus Crisis." The following are a few of my latest thoughts for this work in progress, combined with Melissa's insights.

When THIS is all over, our recent history will be divided into the years before the Great Virus Crisis (B-GVC) and the years after (A-GVC). The demarcation will also be marked by the remarkable and momentous monetary pivot by the Fed on March 23. Prior to that infamous date and starting in late 2008, the Fed implemented unconventional monetary policies like ZIRP (zero interest-rate policy), QE (quantitative easing), and forward guidance to fight the recessionary and deflationary forces resulting from the Great Financial Crisis (GFC).

All these unconventional policies became all too conventional. That was evident when, on Sunday, March 15, the Fed responded to the GVC by lowering the federal funds rate by 100bps to zero and announcing QE4 bond purchases of \$700 billion without any set monthly schedule. There was no shock-and-awe impact on financial markets because it was all too familiar (more like aw-shucks!). Instead, the S&P 500 tanked 12.0% on Monday, March 16. To be fair, that day, President Trump also pivoted away from his "just a bad flu" attitude about

COVID-19 to recommending that all nonessential workers stay home for 15 days. Nevertheless, it was widely perceived that the Fed had run out of ammo for its monetary bazookas.

One week later, on March 23, the Fed implemented QE4ever. Then on Friday, March 27, the President signed the CARES Act, which provides numerous lifelines for unemployed workers, small businesses, airlines, and healthcare companies. In addition, the Fed's fire power was greatly expanded by Section 4003(b) of the Act, which appropriates \$454 billion for the Treasury to backstop as much as \$4 trillion in Fed lending programs aimed at supporting credit flows to businesses, states, or municipalities in the midst of the coronavirus pandemic.

The resources of the Treasury and the Fed were combined in a way that Ben Bernanke had previously described as "helicopter money." However, bazooka and helicopter analogies are so yesterday—so B-GVC. Melissa and I view the consolidated efforts of the Treasury and the Fed from both a policy and accounting sense as "B-52 money."

Now let's review the available data from just before the end of the B-GVC era, and then consider how B-52 money might have changed the course of the war against the virus, at least on the financial front for the benefit of stock investors:

(1) *From reach-for-yield to dash-for-cash.* During the four weeks through March 25, bond mutual funds and exchange traded funds (ETFs) had net cash outflows totaling a whopping \$265 billion ([Fig. 1](#)). That included \$221 billion out of taxable bond funds and \$44 billion out of municipal bond funds. By comparison, equity mutual funds and ETFs had net outflows of \$56 billion over the same period ([Fig. 2](#)). All of the above are estimates derived by the Investment Company Institute.

Where did all that money go? Investors who had been reaching for yield B-GVC suddenly were dashing for cash A-GVC. Liquid assets—i.e., total savings deposits (including money market deposit accounts), small-time deposits, and total money-market mutual funds held by individuals and institutions—jumped \$685 during the four weeks through March 23 ([Fig. 3](#) and [Fig. 4](#)). Over this same four-week period, the components of liquid assets changed as follow: total savings deposits (\$357b), small-time deposits (-\$10b), individual money-market funds (\$68b), and institutional money-market funds (\$270b) ([Fig. 5](#)).

(2) *Wildly volatile VIX and credit spreads.* The S&P 500 VIX soared to a record high of 82.69 on March 16 ([Fig. 6](#)). That slightly exceeded the November 20, 2008 peak of 80.86. It was back down to 45.24 on Monday. The high-yield corporate bond yield spread jumped to 1,062bps on March 23 ([Fig. 7](#)). It was back down to 907bps on Monday. The AAA municipal yield spread vaulted to 188bps on March 23. It was back down to 104bps on Monday.

Strategy II: The Great Rebalancing After QE4ever. In the March 30 [Morning Briefing](#), I noted that many of our institutional accounts told me in telephone and video conference calls that they were unable to capitalize on what they saw as a buying opportunity after the GVC depressed the S&P 500 following its February 19 record high. In particular, balanced funds couldn't take advantage of the great opportunity they saw to rebalance away from bonds and into stocks because the bond markets had frozen up, making it impossible to raise cash by selling bonds.

That all changed on March 23. We noted that institutional investors rushed to sell their bonds to the Fed and used the cash to rebalance into equities. We think investors still have plenty of bonds to sell to the Fed, which will bring in cash with which to buy stocks. That would support our belief that the bear-market bottom was made on March 23.

Central Banks: All Together Now. The world's major central banks are pumping lots of liquidity into their financial markets and economies—and fast—to mitigate the damage of the GVC on both. Each has committed to open-ended QE asset purchases; each has targeted their key interest rates at zero or slightly below; and each has provided financial support for fiscal stimulus measures. Let's review some recent developments among the three major central banks:

(1) *The Fed is heading toward infinity and beyond.* Our March 30 *Morning Briefing*, linked above, reviewed the measures that the Fed has taken so far. The Fed's balance sheet is expanding rapidly in record territory. During the past two weeks through April 1, the Fed's assets rose \$1.1 trillion, with its holdings of US Treasuries, agency debt, and mortgage-backed securities up \$676 billion and liquidity-related facilities expanding by \$467 billion ([Fig. 8](#) and [Fig. 9](#)). All that cash certainly explains why stock prices have recovered so sharply since March 23.

(2) *ECB and BOJ taking a stand in negative territory.* Early in March, ECB President Christine Lagarde said that the bank was ready to take "appropriate and targeted" measures to deal with

the economic fallout from the virus, [according](#) to Reuters. On March 12, the ECB [announced](#) a comprehensive package of monetary policy measures, but disappointed markets when it did not cut interest rates. Nevertheless, the bank remains committed to maintaining historically low interest rates on the main refinancing operations, the marginal lending facility, and the deposit facility at 0.00%, 0.25% and -0.50%, respectively.

Like the ECB, the BOJ resisted lowering its key short-term rate further into negative territory from -0.10% during an emergency March 16 meeting. It also maintained its zero percent target for 10-year Japanese government bond yields, according to the bank's [statement](#). The central bank did, however, significantly increase the supply of funds and added generous support to the equity markets, as discussed below. The BOJ's March easing was intended to address the immediate market distress, so more may come when the bank's policy committee meets next on April 27-28; BOJ Governor Haruhiko Kuroda said as much after the March meeting, [according](#) to Reuters.

(3) *ECB is the Eurozone's buyer of last resort.* The ECB provided massive funding to support bank lending to small and medium-sized businesses (SMEs), or "those affected most by the spread of the coronavirus," stated the March 12 press release on the decision. Lagarde said during her post-decision [press conference](#) that the ECB felt this would more effectively support the financial system than would broadly lowering interest rates.

Substantially lower rates were granted to banks to support SME lending, with more favorable terms offered from June 2020 to June 2021 for the ECB's targeted longer-term refinancing operations (TLTRO III, initiated in 2019). The interest rates on these operations will be at least 25bps lower than the ECB's main interest rate (0.00%) and as much as 25bps lower than the rate on the deposit facility (-0.50%) for a current range of -0.25% to -0.75%. In other words, the ECB is paying banks generously to lend to SMEs!

COVID-19 has been a "major shock" to the growth prospects of Eurozone economies, Lagarde said during her press conference. To mitigate the significant impact on economic activity, the ECB's initial package included incremental long-term repurchase agreements (LTROS) to support the euro area financial system, an increase in the net asset purchase plan by €120 billion for the rest of 2020, and a continuation of the bank's commitment to roll over maturing assets in its portfolio into new purchases for "as long as necessary," at least until after it raises rates. It will focus its asset purchases on the private sector to support the "real economy" in these "heightened times of uncertainty."

The March 12 statement said that the ECB “does not see material signs of strains in money markets or liquidity shortages in the banking system” but that the new LTRO operations to be offered at a rate equal to the deposit facility (-0.50%) “will provide an effective backstop in case of need.” These immediate operations will “bridge the period” until the TLTRO III period begins in June 2020, which will extend lending up to 50% of the previous loan book for banks at the rates discussed above.

On March 18, the ECB released an even greater shock-and-awe measure with its €750 billion Pandemic Emergency Purchase Programme (PEPP). Purchases will be conducted in a flexible manner, across asset classes and jurisdictions, the ECB’s PEPP [statement](#) said. The purchases will not end until the ECB “judges that the coronavirus Covid-19 crisis phase is over, but in any case not before the end of the year.” The central bank committed to explore “all options and all contingencies to support the economy through this shock.”

The ECB’s balance sheet jumped €359 billion during the two weeks ending March 27, mostly attributable to a €209 billion increase in the LTRO account ([Fig. 10](#) and [Fig. 11](#)).

(4) *BOJ doing much more of the same.* On March 16, the BOJ raised its total target for corporate bond holdings and commercial paper by ¥1 trillion each, to ¥4.2 trillion and ¥3.2 trillion. It also pledged to double the annual pace at which it would purchase equity ETFs and J-REITs to around ¥12 trillion and ¥180 billion. The incremental purchases are set to continue until September. Additionally, the BOJ created a new loan program that extends one-year, interest-free loans to financial institutions.

The BOJ already owns around 50% of outstanding Japanese government bonds. Within a year, the BOJ will hold more than a fifth of the shares of at least five companies, JPMorgan estimates, according to an April 6 Bloomberg [article](#). The BOJ balance sheet jumped to yet another record high during March ([Fig. 12](#)).

(5) *Tactical retreat on the inflation front.* The BOJ’s March 16 statement said that it will “pay close attention to the possibility that the momentum toward achieving the price stability target will be lost. The Bank will closely monitor the impact of COVID-19 for the time being and will not hesitate to take additional easing measures if necessary.”

The ECB has committed to policy accommodation until a “robust” return to inflation becomes visible. During her press conference, Lagarde said that it is “very likely that inflation will be lower than whatever we had forecasted this year.” According to the bank’s pre-COVID-19 forecasts, it could take years for inflation in the Eurozone to reach the bank’s target of just below 2.0%.

(6) *Stimulating fiscal stimulators*. Lagarde repeatedly has called upon Eurozone governments to help support the global economy, asserting that central banks can’t carry the onus alone—including at her latest press conference: All policy institutions, she said, are “called upon to take timely and targeted actions to address the public health challenge of containing the spread of the coronavirus and mitigate the economic impact.” Lagarde said with disappointment that the Eurozone’s fiscal efforts as of her press conference amounted to less than 1.0% of GDP.

Referring to her predecessor Mario Draghi who delivered on his pledge to “do whatever it takes” to defend the euro following the previous crisis, she added: “I don’t have a claim to history for being whatever-it-takes number two. I really would like all of us to join forces, and I very much hope that the fiscal authorities will appreciate that we will only deal with the shock if we come together.” That statement was before Lagarde’s turn on March 18 when she went all in with PEPP, thereby assuming the whatever-it-takes mantle she disavowed. But that doesn’t mean that she has given up on enlisting fiscal support.

The BOJ’s statement in response to the viral outbreak also acknowledged the government’s role of providing fiscal stimulus, saying that the bank’s monetary easing will support economic activity along with the government’s various measures to do so.

As for what governments are doing to help, Germany’s Chancellor Angela Merkel just [unveiled](#) plans for a limitless credit program for small businesses on top of its historic virus [bailout](#) package. Declaring a coronavirus state of emergency yesterday, Japanese Prime Minister Shinzo Abe approved a huge ¥108 trillion (\$990b) plan to combat the virus, [reported](#) CNBC. Japan’s fiscal stimulus efforts will amount to a whopping 20.0% of GDP and Germany’s about 5.0%—versus about 11.0% for the US, observed the CNBC article.

To infinity and beyond!

CALENDARS

US: **Wed:** MBA Mortgage Applications, DOE Crude Oil Inventories, FOMC Meeting Minutes. **Thurs:** Consumer Sentiment Index 75.0, Jobless Claims 5.0m, EIA Natural Gas Storage, Baker-Hughes Rig Count. (DailyFX estimates)

Global: **Wed:** Kuroda. **Thurs:** UK GDP 0.1%_{m/m}/0.1%_{3m/3m}, UK Headline & Manufacturing Industrial Production -3.0%/-4.0% y/y, Canada Employment Change & Unemployment Rate - 500k/7.4%, Japan Consumer Confidence 35.0, China New Yuan Loans & Aggregate Financing ¥1800b/ ¥2800b, China CPI & PPI 4.9%/-1.1% y/y. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500 Growth vs Value ([link](#)): The S&P 500 Growth and Value price indexes were down sharply on 3/23 from their record highs, but have improved markedly since then. Growth leads ytd through Monday's close, albeit with a drop of 11.8% versus a 24.0% decline for Value. Since their low for the year on 3/23, Growth's 18.5% gain is lagging the 19.8% rise for Value. Growth is back in a correction at 18.8% below its 2/19 record, but Value is still in a bear market at 24.9% below its 1/17 record high. Looking at the fundamentals, Growth is expected to deliver higher revenue growth (STRG) and earnings growth (STEG) than Value over the next 12 months. Specifically, 6.4% STRG and 8.9% STEG are projected for Growth, respectively, versus 1.2% and -0.2% for Value. Growth's valuation peaked at 24.2 on 2/19, its highest level since April 2002 when the Tech bubble was deflating. Through Monday's close, Growth's P/E was back up to 20.4 from its 15-month low of 16.8 on 3/23. Value's forward P/E was back up to 12.5 from 10.0 on 3/23, which was its lowest reading since November 2011. Regarding NERI, Growth's was negative in March for an eighth straight month as it tumbled to a four-year low of -9.2% from -1.9% in February. That compares to a record high of 22.3% in March 2018. Value's NERI was negative in March for a 17th month, and down to a 47-month low of -13.8% from -6.2%; that compares to a record high of 21.2% in March 2018. The Tax Cuts and Jobs Act (TCJA) sharply boosted the consensus forward earnings estimates and the forward profit margin for both Growth and Value in 2018. Growth's forward profit margin of 15.9% is up from 14.4% prior to the TCJA's passage but down from its record high of 16.7% during September 2018. Value's forward profit margin of 9.5% is down from a record high of 10.5% in December 2018, and barely above the 9.1% prior to the TCJA.

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