Investment Insights

Market Sell-Off Continues Despite Fed Actions

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Equity markets sold off sharply Thursday with the S&P falling 9.5%; its peak-to-trough decline is now almost 27%. The spread of COVID-19 continues to create significant uncertainty, and so far, the response from the U.S. government has disappointed investors looking for broad-based stimulus to combat the negative economic impact. Our piece on Monday mentioned that an area of particular focus for us was corporate funding. As funding markets have tightened this week, this was the main driver of the market sell-off on Thursday. Stress was visible in dollar funding markets and other short-term funding markets, and the decline in assets was broad-based and somewhat disorderly, rather than a more typical "risk-off" dynamic. For example, gold prices declined and the 30-year bond saw yields higher (and prices lower) on the day.

Fed actions today appeared primarily targeted at providing liquidity. The reprieve they provided for equity markets, however, was short-lived. Responding to the market volatility and concern around waning liquidity in bond markets, the Fed announced it will open the floodgates of liquidity by offering $1.5 trillion worth of term repo to the banking system over the next two days. ("Repo" is short for repurchase agreement, and in this case, it is a transaction in which a financial institution sells securities, often Treasuries, to the Fed, agreeing to repurchase the securities at the end of the term at cost plus interest. This allows the bank to increase its cash holdings.) The full amount offered will include $500 billion in 3-month term repo today and Friday, as well as another $500 billion in 1-month term repo also on Friday. 1-month and 3-month repurchase agreements of $500 billion each will be offered on a weekly basis for the remainder of the monthly schedule, which will be a large boost to liquidity.

With higher cash balances, the banking system will be in a better position to support whatever needs may arise in the rest of the economy as a result of market and economic stress. This became especially important in the most recent trading sessions as liquidity markets were tightening. It is likely that companies directly affected by the virus have drawn on credit facilities, putting some pressure on banks for short-term liquidity. While banks overall are well-capitalized and do not show excessive leverage, liquidity can be challenging when markets are forced to cope with exogenous shocks. Related to this, but a different source of stress, has been demand for U.S. dollar liquidity from foreign central banks.

The Fed also announced it will broaden its purchases, currently of $60 billion T-Bills per month, to include longer-duration Treasury notes and bonds. This will help maintain liquidity and order in the Treasury market as well as keep downward pressure on longer-term yields, thereby reducing the cost of capital for businesses. These measures are aimed at settling markets in the short run in the hope the federal government will soon announce supportive fiscal programs to ease the effects of the coronavirus, oil price pressure, and market unease. We note that the NY Fed announced these measures, rather than the Board of Governors, as the Fed seems to be signaling these moves are more about liquidity than monetary policy. In our opinion, the distinction is academic and irrelevant, and the step is essentially additional quantitative easing.

More is likely needed from the Fed as it relates to liquidity and backstops for affected industries. We would expect that today's announcement is merely the start of additional measures the Fed may take in the coming weeks. Fiscal policy from the federal government can be helpful, but the Federal Reserve is the most efficient conduit of capital to the parts of the economy that need it the most in the short-run. In addition to liquidity operations, we believe additional monetary policy easing is likely in the coming days.

While market disruptions will likely continue in the short-term, policymakers acknowledging liquidity stresses is a positive step.

For more information on the recent market developments, we encourage you to read our March 9 *Investment Insights,* "Latest Thoughts on Market Turmoil", our February 28 *Investment Insights*, "Taking a Long-Term View During Volatile Times," and our February 25 *Investment Insights*, "Portfolio Positioning Amid Recent Market Moves."

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