PeoplesBank
WEALTH MANAGEMENT

Historic Week and the Fed's Bazooka
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Last week was a historic week in the US financial markets. There is no better phrase to describe the week than outright panic. Let me provide a few examples. On March 13th (a week ago Monday), the S&P 500 had its 3rd largest decline on record. Secondly, an ETF that tracks long-term treasury bonds (which are generally considered default-free), gained 6.5% one day and lost 6.7% the next day. These were the ETF's largest one day gains and losses since its inception in 2002. Gold, also considered a safe haven, went down in value last week. In the bond market, risk aversion increased at its fastest rate in history among both investment grade and high yield bonds and investment grade corporate had their worst week of underperformance versus treasuries ever.

In theory, what I just described should not happen all at the same time. So why did it? Well, last week investors en masse decided that they did not want to hold any asset but cash, and they decided to sell assets of all types. This desire for nothing but cash caused both an extreme spike in volatility and the plumbing of the financial system to become severely clogged. Let's examine each of these outcomes in turn. To quantify extreme volatility, the VIX index, which is known as the market's "fear gauge", spiked to its highest level on record, even higher than the level it reached right after the collapse of Lehman Brothers in 2008. This volatility spike itself caused problems for the stock market. This is because the marginal trader in the markets is now a computer and most computer based-traders use some variation of the same risk-management system. This system boils down to reducing stock exposure as volatility increases. This causes a negative feedback loop in which more selling causes volatility to increase which causes more selling. Fortunately, based upon various measures, it looks like this volatility-induced selling has run its course, and should not be a factor again in the near term.

Turning to the financial market plumbing, investors' sudden and extreme desire to hold only cash overwhelmed the system's ability to function properly and several credit markets seized up. One of these markets was the commercial paper market in which corporations borrow money short-term (for several weeks). Because commercial paper had trouble trading, this began to cause problems for money market mutual funds that owned this commercial paper. These money market funds were having trouble selling commercial paper to meet investor redemptions. Also as mentioned previously, the corporate bond market had its worst week on record relative to treasuries as investors went to sell them to raise cash. Risk aversion also increased rapidly in the municipal bond market. Finally, because it was difficult to find buyers, some large ETFs (exchange traded funds) that held corporate bonds and municipal bonds started to trade at large discounts to the value of the underlying bonds.

This leads us to the Fed's bazooka. Seeing the financial markets seize up in a way reminiscent to what occurred in 2008, the Fed fired an extremely enormous bazooka and implemented several policies last week and this morning that should unclog the system. First, the Fed will re-institute quantitative easing and begin to purchase both treasury bonds and mortgage-backed securities in "unlimited amounts". New to this round of quantitative easing will be the purchase of commercial mortgage-backed securities. Secondly, the Fed will support the commercial paper market by setting up an entity to purchase commercial paper issued directly by corporations. Third, the Fed will set up another entity to purchase securities directly from money market mutual funds that need to sell to meet investor redemptions. These policies just described were generally taken from the Fed's 2008 playbook. The final policy they announced this morning is the newest and most radical. The Fed will now purchase investment grade corporate bonds, and corporate bond ETFs from private sector bond holders directly from corporations issuing those bonds. Taken in total, the Fed will now backstop almost all markets except the stock market and the below investment grade bond market.

So where does this leave us? We think that the Fed has effectively ended the liquidity problems that the market was facing. Said another way, we think that markets should function properly going forward. Now that the liquidity problem is out of the way, we need Congress to act to pass an initial stimulus package to help mitigate some of the economic damage caused by the pandemic. We think this is the next essential step in order for the stock market to find an initial bottom. At the time of the writing, the two parties were still haggling over the deals of the bill. Looking out a little bit further, bottoming is typically a process, and we expect that the market will need more clarity on the eventual economic impacts before making a final bottom and entering the first phase of a future recovery.

We will continue to follow events closely, and we stand ready to change our recommendations as the situation evolves. Please reach out with any questions or concerns you may have.

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