Monetary and Fiscal Stimulus: The Twin-Barreled Response to COVID-19

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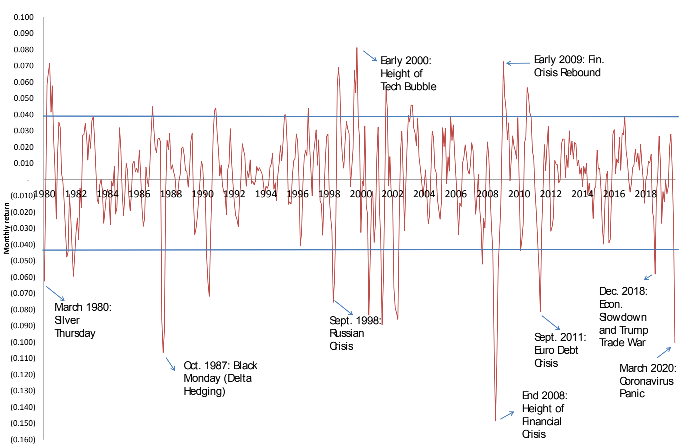
Prior to a very sharp rally in the last two weeks, the one month U.S. stock market performance was in dubious company indeed. Looking at the worst pullbacks in the last century, the Dow Jones Industrial Average in March 2020 had the second worst performance ever, only slightly trailing September 1931, at the height of the Great Depression. In fact, our BMO Nesbitt Burns North American Risk Appetite Index attained the highest level of panic since the height of the Financial Crisis of 2008/09.

Figure 1: BMO Nesbitt Burns Risk Appetite Index[1]



Source: BMO Nesbitt Burns, Bloomberg

And yet, aside from equity market performance figures, the bearish narrative that we are headed toward another great depression completely misses the mark, in our opinion. This is because, in the late 1920s/early 1930s, the policy response was exactly the opposite of what was needed to re-instill confidence for individuals and businesses. In particular, allowing a contraction in the money supply (in part because of the gold standard), trying to balance the budget instead of stimulating the economy, protectionist policies and allowing businesses and banks to fail in alarming numbers, are just a few of the most egregious mistakes that took place during this time. Having learned several lessons from history, central banks and governments are thankfully reacting quickly and aggressively to the unprecedented shock we are facing.

Since the market is a leading indicator of the real economy (typically by 3 to 6 months), the huge market pullback was a prelude to the type of dismal economic data we have started seeing in most countries. The fact that we have entered a global recession is now a foregone conclusion with many countries on full or severe lockdown. This has crushed economic activity and the stock and fixed income markets are already discounting a severe downturn. The crucial question at this point is how long the downturn will last. And this, in turn, will depend on when new COVID-19 infections peak and life returns to some semblance of normalcy. Encouragingly, this is already starting to happen in Asia. There are early signs that aggressive social distancing guidelines are having a positive impact in hard hit Italy and Spain, and on the growth of infections in Washington State and in British Columbia as well. As we have noted before – and this is critical for equity investors – the stock market will begin to rebound well before the economic data or even the newsflow improve. From that perspective, the powerful rally we have witnessed could be the beginning of the rebuilding process. We hasten to add, however, that we fully expect elevated volatility to persist for a while longer.

On a positive note, monetary and fiscal authorities are taking this issue very seriously. Global central banks have announced unprecedented monetary stimulus including lower short-term policy rates, new or increased asset purchase programs (e.g. buying fixed income securities) to maintain longer-term yields low and targeted lending facilities to provide short-term

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liquidity. Notably, Doug Porter, BMO's Chief Economist, writes that, "the Bank of Canada fully matched the Fed's total rate changes with [its own] 50 bps cut, and finally embarked on Quantitative Easing (QE)." Recall that the Bank of Canada ("BoC") was one of the few holdouts on the QE front in the 2009 crisis, so this is a very big shift. The BoC will buy at least $5 billion of Government of Canada bonds weekly "until the recovery is well under way," which likely will bring the total to well above $100 billion (essentially funding the new fiscal measures). However, the Coronavirus creates an economic problem that interest rates alone cannot solve. After all, what good are zero interest rates to a restaurant which has seen its business activity drop by 80 percent or more?

This is where fiscal stimulus comes in. Concurrent with its declaration of a state of emergency related to the Coronavirus, Japan just announced a 108 trillion yen (approximately US$1 trillion) economic package which corresponds to a massive 20% of GDP. The U.S. Senate approved a $2 trillion* fiscal support package and many European countries have announced measures totaling 10% of GDP or more. Ottawa also announced that wage subsidies for small and medium businesses will be cranked up to 75% (from the initial 10% proposal), a huge step up.

Since we are starting from generally elevated debt levels globally, we truly hope that countries, provinces and states will remember to repay some of that debt when the economy improves. This is the part of the Keynesian doctrine that politicians consistently seem to forget and it presents a significant longer term risk.

Low Interest Rates for Longer than Expected

To help repay those loans, low interest rates will be needed to provide financial flexibility and they will be needed for a longer period than initially forecasted. Both the Bank of Canada and the U.S. Federal Reserve responded aggressively, in less than a month cutting policy rates by 150 bps to a low of 0.25%, the lowest since the great Financial Crisis. While these cuts pale in comparison to prior crises, clearly central bank officials have limited appetite for negative interest rates at this juncture.

Early indications confirm that the introduction or extension of new liquidity measures from central banks, including lending facilities and broad fixed income asset purchases contributed to calming markets. It helped stabilize and provide much needed support to risk assets in general and as a result lower market volatility. Corporations are issuing debt again with investor demand strengthening and yield spreads tightening from relatively wide levels.

As the crisis evolves, low interest rates will become more important in the relief effort and the recovery process. Not only financial institutions, but other businesses and households will benefit from access to inexpensive funding. This will greatly contribute to the speed and strength of the economic recovery. Understandably, as balance sheet leverage increases to weather the storm, low interest rates will need to remain in place for a prolonged period to help with the increased financial obligations.

While the environment will remain volatile for some time and more downside risk is certainly possible, the key is to maintain a well diversified portfolio including cash, bonds, and high quality stocks. Please contact your BMO financial professional if you would like to discuss your investment portfolio.

[1] BMO Nesbitt Burns North American Risk Appetite Index background and methodology: In the summer of 2017, the proprietary BMO Nesbitt Burns North American Risk Appetite Index ("RAI") was created. The RAI attempts to minimize the emotion and bias which are prevalent in a number of market indicators. In order to do this, we use exclusive market price data and compare the relative performance of risky assets (a composite of the S&P 500, S&P/TSX, Philly Semiconductor Index, Nasdaq Biotech Index, and several other indices) versus safe assets (several Canadian and U.S. Government, provincial and municipal bond indices). Simply put, when stocks are outperforming bonds, the RAI goes up and when bonds do better than stocks (which is typical when investors fear an economic slowdown for example), the RAI goes down.

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