

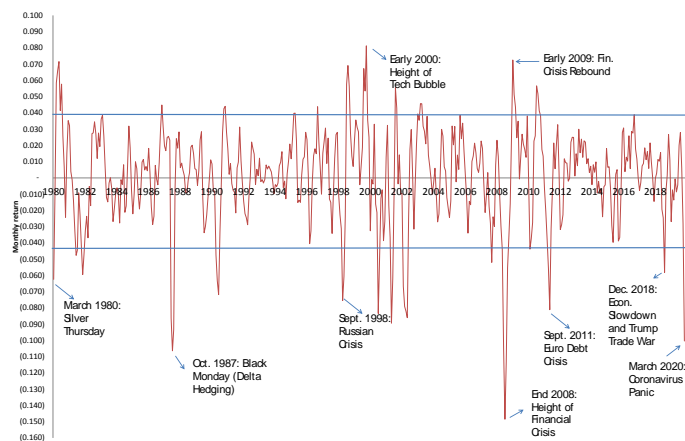
# Monetary and Fiscal Stimulus: The Twin-Barreled Response to COVID-19

Stéphane Rochon, CFA, Equity Strategist

Richard Belley, CFA, Fixed Income Strategist

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<sup>1</sup>**



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

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<sup>1</sup> 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.

<sup>1</sup> 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.



#### General Disclosure

The information and opinions in this report were prepared by BMO Nesbitt Burns Inc. Portfolio Advisory Team ("BMO Nesbitt Burns"). This publication is protected by copyright laws. Views or opinions expressed herein may differ from the views and opinions expressed by BMO Capital Markets' Research Department. No part of this publication or its contents may be copied, downloaded, stored in a retrieval system, further transmitted, or otherwise reproduced, stored, disseminated, transferred or used, in any form or by any means by any third parties, except with the prior written permission of BMO Nesbitt Burns. Any further disclosure or use, distribution, dissemination or copying of this publication, message or any attachment is strictly prohibited. If you have received this report in error, please notify the sender immediately and delete or destroy this report without reading, copying or forwarding. The opinions, estimates and projections contained in this report are those of BMO Nesbitt Burns as of the date of this report and are subject to change without notice. BMO Nesbitt Burns endeavours to ensure that the contents have been compiled or derived from sources that we believe are reliable and contain information and opinions that are accurate and complete. However, BMO Nesbitt Burns makes no representation or warranty, express or implied, in respect thereof, takes no responsibility for any errors and omissions contained herein and accepts no liability whatsoever for any loss arising from any use of, or reliance on, this report or its contents. Information may be available to BMO Nesbitt Burns or its affiliates that is not reflected in this report. This report is not to be construed as an offer to sell or solicitation of an offer to buy or sell any security. BMO Nesbitt Burns or its affiliates will buy from or sell to customers the securities of issuers mentioned in this report on a principal basis. BMO Nesbitt Burns, its affiliates, officers, directors or employees may have a long or short position in the securities discussed herein, related securities or in options, futures or other derivative instruments based thereon. BMO Nesbitt Burns or its affiliates may act as financial advisor and/or underwriter for the issuers mentioned herein and may receive remuneration for same. Bank of Montreal or its affiliates ("BMO") has lending arrangements with, or provides other remunerated services to, many issuers covered by BMO Nesbitt Burns' Portfolio Advisory Team. A significant lending relationship may exist between BMO and certain of the issuers mentioned herein. BMO Nesbitt Burns Inc. is a wholly owned subsidiary of Bank of Montreal. Dissemination of Reports: BMO Nesbitt Burns Portfolio Advisory Team's reports are made widely available at the same time to all BMO Nesbitt Burns investment advisors. Additional Matters TO U.S. RESIDENTS: Any U.S. person wishing to effect transactions in any security discussed herein should do so through BMO Capital Markets Corp. ("BMO CM") and/or BMO Nesbitt Burns Securities Ltd. ("BMO NBSL") TO U.K. RESIDENTS: The contents hereof are intended solely for the use of, and may only be issued or passed onto, persons described in part VI of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2001. BMO Wealth Management is the brand name for a business group consisting of Bank of Montreal and certain of its affiliates, including BMO Nesbitt Burns Inc., in providing wealth management products and services.

BMO Wealth Management is a brand name that refers to Bank of Montreal and certain of its affiliates in providing wealth management products and services. Not all products and services are offered by all legal entities within BMO Wealth Management.

BMO Private Banking is part of BMO Wealth Management and is a brand name under which banking services are offered through Bank of Montreal, investment management services are offered through BMO Private Investment Counsel Inc., a wholly-owned indirect subsidiary of Bank of Montreal, and estate, trust, planning and custodial services are offered through BMO Trust Company, a wholly-owned subsidiary of Bank of Montreal.

BMO Nesbitt Burns Inc. provides comprehensive investment services and is a wholly-owned subsidiary of Bank of Montreal. If you are already a client of BMO Nesbitt Burns Inc., please contact your Investment Advisor for more information. All insurance products and advice are offered through BMO Estate Insurance Advisory Services Inc. by licensed life insurance agents, and, in Quebec, by financial security advisors. If you are already a client of BMO Nesbitt Burns, please contact your Investment Advisor for more information.

BMO Nesbitt Burns Inc. is a Member-Canadian Investor Protection Fund. Member of the Investment Industry Regulatory Organization of Canada.

BMO CM and BMO NBSL are Members of SIPC. © BMO and the roundel symbol are registered trade-marks of Bank of Montreal, used under license.