Market Perspectives

PRIVATE CLIENT SOLUTIONS

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September 11, 2020

Pandora's Box

The financial crisis (GFC) created many dislocations in the US economy and beyond - as you can see in the chart below ultra-loose monetary support was lent to the economy for well over 5 years. Not only did the US Federal Reserve keep rates low, but they continued to expand their balance sheet by buying government and mortgage backed securities. In fact, the Fed only began to shrink its balance sheet in 2018, a full decade after the crisis. The pandemic's impacts have been far more reaching than the credit crisis. As such, the prospects for extraordinary measures remaining in place, not only in the US but in Canada, seems to be a reasonable assumption.

- At the BoC's meeting, the Governing Council said the policy interest rate would be maintained at the effective lower bound until economic slack is absorbed so that the 2% inflation target is "sustainably achieved". Sustainably achieved suggests rates will remain at current levels until inflation crosses 2%, which is a departure from how the Bank has historically approached inflation.

- Taking a page from the Fed's GFC response, the BoC has also engaged in a quantitative easing (QE) program targeting government and corporate bonds. This large-scale asset purchase program was reiterated during the last meeting with the BoC planning to soak up at least $5 bln per week of government of Canada bonds to further support the government's fiscal measures.

- The groundwork for today's monetary response was laid a decade ago. The Fed's asset purchase program (QE) helped keep a lid on rates, lowering the cost of borrowing for corporations and credit worthy individuals, but one of the criticisms is that it disproportionately benefited Wall Street over Main Street. What was missing in the GFC response was received this time around – fiscal measures directed towards Main Street (individuals).

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The Bank of Canada (Boc) maintained its target overnight lending rate at the effective lower bound of 0.25%. The BoC has scheduled two meetings for the remainder of the year and one will notice a very similar trend developing; the overnight rate is not going anywhere anytime soon. The severity of the contraction and significant number of unemployed individuals will ensure monetary conditions will remain loose for some time, which we witnessed following the last crisis.

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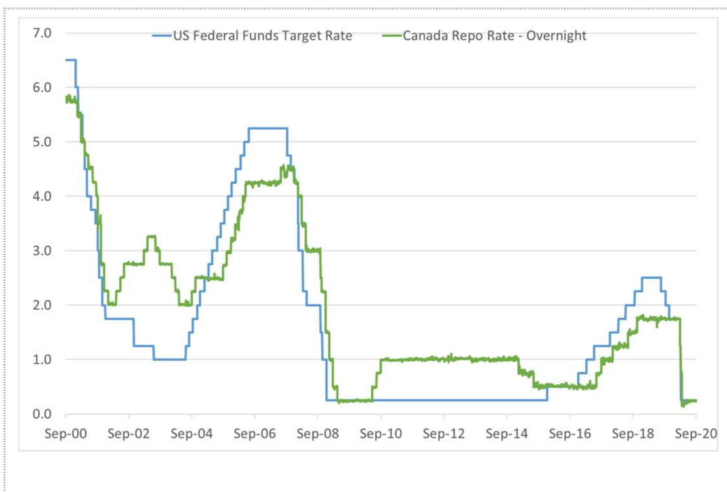
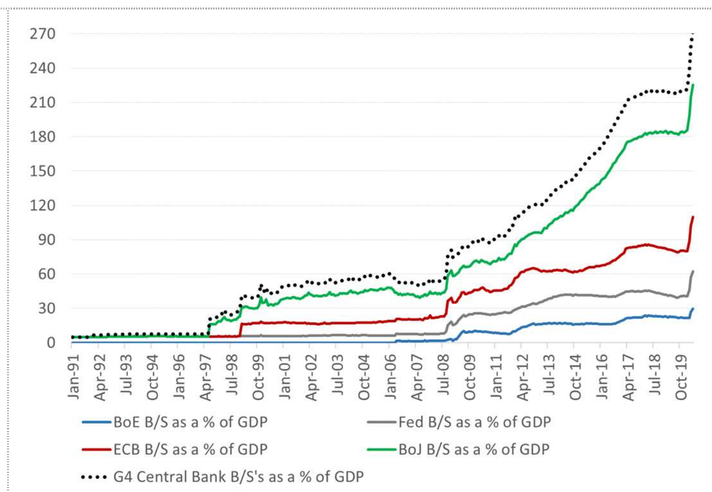
BoC & Fed Funds Rates Ultra-loose After GFC…



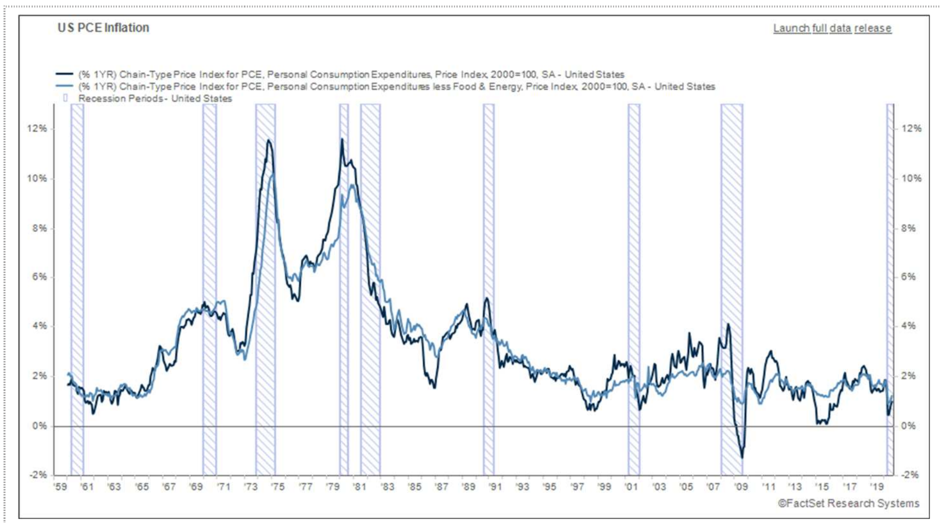
…Central Bank Balance Sheets Also Lent Support



Source: FactSet, Raymond James Ltd.

At the BoC's meeting, the Governing Council said the policy interest rate would be maintained at the effective lower bound until economic slack is absorbed so that the 2% inflation target is "sustainably achieved". Sustainably achieved suggests rates will remain at current levels until inflation crosses 2%, which is a departure from how the Bank has historically approached inflation. In the past, as inflationary pressures rose, the BoC would begin to raise rates ahead of achieving its target; this time around it appears inflation will be allowed to overshoot. The US Fed is taking a similar approach by targeting average inflation, meaning they will make up for lost ground by allowing inflation to run above target. We will receive more information about this rather significant policy shift at the FOMC meeting next week. In addition, market participants will be looking for clarity on how the strategy will be implemented and how the Fed intends to generate higher inflation considering inflation has undershot its target for many years. Next week's meeting may also provide some insights into potential new tools to support economic growth, which will be of keen interest given the depleted policy arsenal.

Fed's Preferred Inflation Measure: PCE Inflation

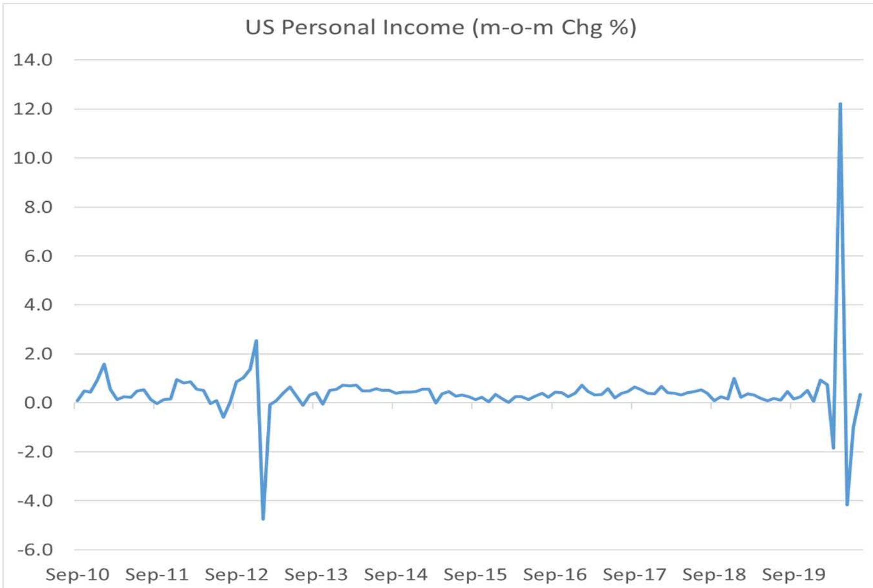


Source: FactSet, Raymond James Ltd.

Pandora's Box

The groundwork for today's monetary response was laid a decade ago. The Fed's asset purchase program (QE) helped keep a lid on rates, lowering the cost of borrowing for corporations and credit worthy individuals, but one of the criticisms is that it disproportionately benefited Wall Street over Main Street. What was missing in the GFC response was received this time around – fiscal measures directed towards Main Street (individuals). Direct cash injections into the hands of the consumer, or helicopter money, goes back to the days of Milton Friedman and has been a subject of much debate leading up to the pandemic. Recall in 2018/19, the global economy was struggling and central banks around the world were cutting their benchmark lending rate. With limited ability to stimulate the economy through interest rates, the concept of Modern Monetary Theory (MMT) began to make its way into economist's lexicon. The Coles Notes on MMT is that governments can essential borrow as much money as needed to stimulate economic growth, achieve full employment and desired inflation. The pandemic has allowed MMT, in part, to be tested in a real world situation. The ultimate outcome is yet to be known, but the near-term impacts are clear. One can simply look at personal incomes and savings rates which exploded higher during the sharpest economic contraction in modern history. Without the fiscal support it would have been a completely different story and the economic outcome more dire than it is today.

Government Transfer Payments - Significant Jump in US Personal Income



Source: FactSet, Raymond James Ltd.

Governments and central banks have shown their willingness to do whatever it takes to keep the economy (and the equity markets) a float. Forced between taking no action and taking aggressive action, the option is always to do more to avoid severe negative outcomes. This is a function of the government and central bank, but it does present challenges. From a market perspective, it signals that risky assets are less risky as governments essentially backstop the market/economy. Of course this statement is only true as long as we all have faith in our institutions. Moral hazard is alive and well, but what other choice do we have now that Pandora's Box has been opened?

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