To QE Infinity and Beyond

Thoughts from the Bond, Income & Defensive Strategies (BIDS) Desk

March 25 2020

A week is not typically considered a long time in markets but the last two weeks will feel like a lifetime for most of us. There's been a lot of information to digest and the frequency and volume of new information every day continues to increase.

The major development has been the announcements of substantial fiscal policies and Quantitative Easing (QE) by most governments and central banks across the world in a very co-ordinated response. We strongly believe this is only the start of what is needed. The magnitude will be substantially larger than what we are seeing right now.

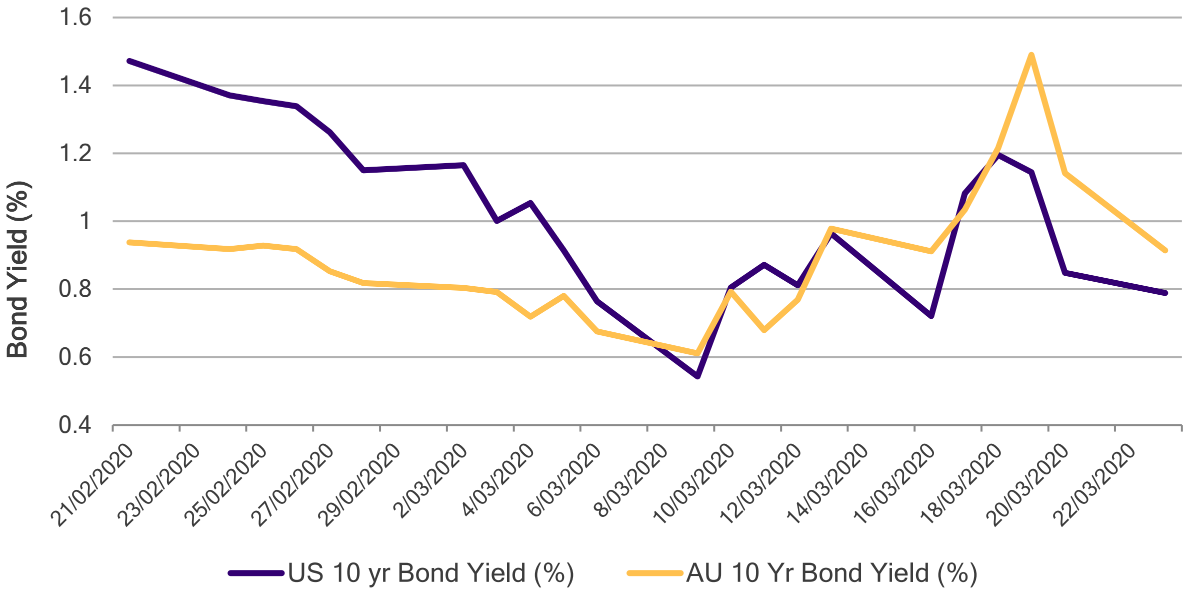
The US Federal Reserve has now moved to the lender of last resort for the whole economy – not just the banking sector – and has agreed to purchase $75 billion per day of all bonds (including corporate investment grade bonds out to 5 yrs). To put this into context during their last QE package they were weekly purchasing $80 billion per week! A considerable step change.

Bonds and Equities in divorce courts

There is no doubt central banks started to get very worried over the last few weeks when they saw the reaction of long-end bond yields to the announcements of fiscal stimulus.

Concern over future issuance to fund these policies saw dramatic moves. As you can see below an example of this move in the Australian and US 10-year bond yields.

The traditional view of negative correlations of bonds and equities during times of market volatility was clearly not present. While not yet in divorce courts, there was definitely a separation at play.



This, combined with a higher US dollar and widening credit spreads, saw financial conditions tighten and threaten to derail the financial system.

The global central bank bond-buying action to alleviate part of this issue will see bond yields converge to zero globally and provide a bid for bonds in this environment.

RBA delivers when it counts

The RBA stepped up meaningfully during the week and delivered a strong, well-messaged response to the current crisis.

In an article titled RBA Brings Out The Howitzer, Pendal's Government Bond Fund Manager and avid RBA watcher Tim Hext wrote: "Phil Lowe may be cautious by nature but he can recognise when decisive action is required. They have delivered. Basically they are flooding liquidity into the system and this will be a big help. I suspect markets will be slow to appreciate how big this is but in months to come it will be seen as the first step to stabilisation."

The market reacted – and continues to react – with Australian bond yields moving down in lockstep across the curve.

One of our key views is that we are likely to see Australian bonds out to 5 years close to zero before this is over.

Credit market seize up

One of the real issues has been concern around the credit markets' ability to function in an environment of such uncertainty.

Unlike equity markets which have more transparency on an exchange (you can sell a security although you may not like the price), credit markets rely on intermediaries to do the trading.

These dealers require two things to be able to price credit securities: the risk-free rate and the risk spread for corporates.

With both of those uncertainties the market has had difficulties in pricing and this has led to increases in trading costs to compensate (and subsequent rise in buy/sell spreads for most fixed interest and credit funds).

The move from the Fed last night acts like a playbook for central banks everywhere.

While not initially large in size, it was a strong message, allowing credit markets to function and companies to at least issue and finance rollovers in the short term.

While every market crisis is different – and this one has the extra impact of a health crisis – the Pendal BIDs boutique continues to stick to our defensive philosophy.

We'll continue actively managing risks for our clients, ensuring we are constantly adjusting our exposures to reflect the latest market information.

Our portfolios have so far held up well during these difficult markets and we are here to help support you with any information or insight we can provide.

Be safe and take care.

For more information contact your
key account manager or visit **pendalgroup.com**

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