Investment Weekly

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Central banks go all out to fight recession

♦ US high-yield bonds see a historic rally after the Federal Reserve says it will begin to buy junk debt.

♦ The Fed announces a program to lend directly to small and medium-sized businesses.

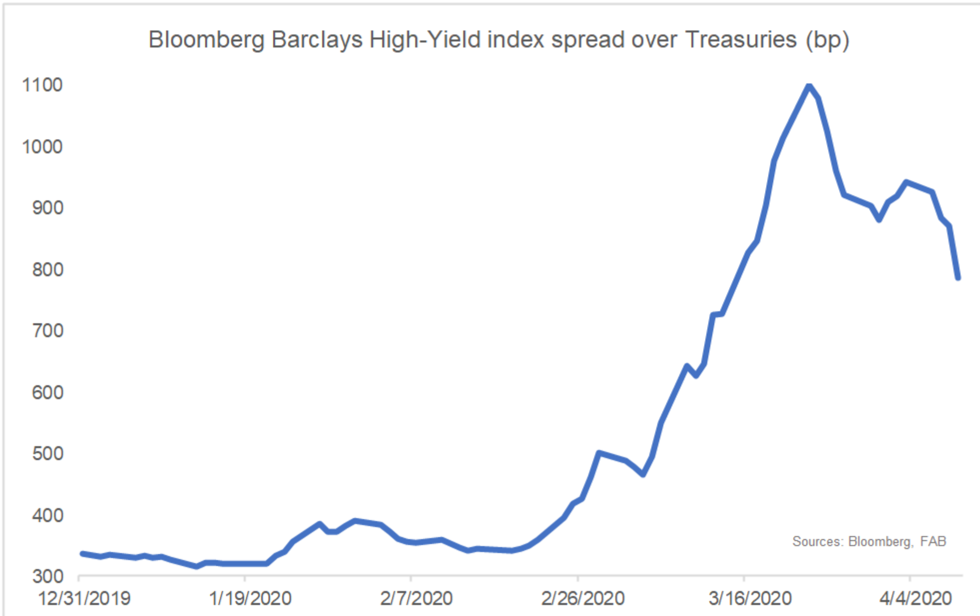
♦ The Bank of England starts buying bonds directly from the government to fund the virus response.

♦ Regulators across the world relax rules to allow banks to lend more.

♦ More than 17 million American have filed for unemployment benefits in just three weeks.

♦ Abu Dhabi raises US$7 billion in bonds and Dubai gets loan while it prepares its own bond deals.

♦ FAB AAC remains underweight equities and overweight gold amid continued uncertainty in markets



Central banks across the world are using every tool at their disposal to help steady the world economy pending the global lockdown being lifted in stages. The Federal Reserve on Thursday announced a new program to buy junk bonds that helped the Bloomberg Barclays US Corporate High-Yield index rally 3.1% that day, one of its biggest one-day rallies in the index's history. US bond markets were closed on Friday for a religious holiday.

The Fed's program is yet to start and will be broadly limited to higher-rated junk bond issuers, especially those that have recently lost their investment-grade status. Markets saw the intervention as a lifeline for the asset class.

The move comes after measures that showed the Fed and other central banks becoming increasingly aggressive in their efforts to stabilize financial markets. The US central bank had already announced unprecedented programs, such as buying corporate and municipal bonds, aside from new versions of other programs it had used in the 2008 crisis.

The result was indisputable. On 23 March, the average yield premium on the Bloomberg High-Yield index hit 1,100 basis points over US Treasuries, the highest since May, 2009. The Fed's forays into corporate bonds and now into junk brought that yield premium back down to 785 basis points on Thursday.

The central bank is not done, according to its governors. Last week's announcement is a program to lend directly to small and medium-sized businesses, Federal Reserve Vice-Chairman, Randal Quarles, said on Friday.

The Fed's entry into junk bonds helped reduce their yield premium further

In similar fashion, the Bank of England provided the UK government with an overdraft through which it will buy bonds from the UK Treasury. In simple terms, the BoE is printing money and giving it to the government in return for IOUs.

While that may draw criticism from many economists, it is hardly new. In fact, two years after the Bank of England had been created, in 1696, the bank issued GBP765,000 in new money used to buy government debt, with that sum backed by only GBP36,000 in collateral, according to Murray Rothbard. Inflation jumped in the decade after that, and the bank needed to intervene, historical data shows. The times are different, but the tool works the same way.

By ‘printing money’, the Fed and the Bank of England are increasing the supply of cash in the hope that an amount of it ends up with common people that need it in what is shaping up to be the worst global economic recession since World War II.

Indeed, while markets have seemingly been recovering from the March sell-off, in reality the jury is still out on whether they are truly out of the woods, especially given the economic data has become more dire by the minute. On Thursday, the US saw a third consecutive week of near-record weekly jobless claims. The Department of Labor revealed that 6.6 million Americans filed for welfare benefits in the week ended 4 April. As a result, a total of 17.2 million people in the US have filed for such benefits since the beginning of March.

To put that in perspective, during the 10 years to 31 January this year the US had created 22.5 million new non-farm jobs. One more week of more than 5 million initial jobless claims will have erased all the jobs the US economy generated in a decade. That spells out a deep recession.

Considering that every worker contributes a fraction of GDP growth, the 15% drop in people employed implies a commensurate drop in activity. A simple extrapolation would see US$3.2 trillion less production in the US economy this year, or a nearly 15% economic contraction. Obviously it is not that simple, and the contraction may be far less severe by year-end. Still, the US is staring at its worst economic conditions since the end of World War II.

The Organization for Economic Co-operation and Development recently estimated that every month of movement restrictions reduces global GDP growth by up to 2 percentage points. Most countries are still grappling with when to lift lockdowns. Italy, for one, extended the closures to 3 May after new cases accelerated last week again, while the UK has no timeline to lift its own closures.

The extent to which that will impact stock markets will become more apparent starting this week, as US and European companies begin to report first quarter results. Most of them have withdrawn profit and revenue guidance for the year, while many have canceled buyback programs and cut executive pay. In addition, further dividend cuts are to expected in several sectors, which could fuel a further reassessment of the value embedded in the stock market right now.

As at 27 March, the dividend yield on the S&P 500 was at 2.35%, its highest since 2009, while the same metric for the European STOXX 600 stood at 4.1%, also the highest in nearly a decade. Those yields looked staggering when compared to benchmark bonds. The 145 basis points of additional yield offered by US stocks on that date was the highest such premium in the past 60 years, at least. From that standpoint alone, stocks should be unbelievably attractive, unless dividends are cut, which is likely to happen.

Perhaps for a timely read on the global economy, investors should watch the oil market instead. Brent crude prices are down 52.3% this year, despite having rallied 36.8% last week alone on hopes that the OPEC+ group would reach an agreement to cut oil output by 10 million barrels/day. The accord was on tenterhooks over the weekend as Mexico refused to meet its output reduction quota, even after Saudi Arabia and Russia, two of the world’s biggest producers, accepted the size of the cut proposed.

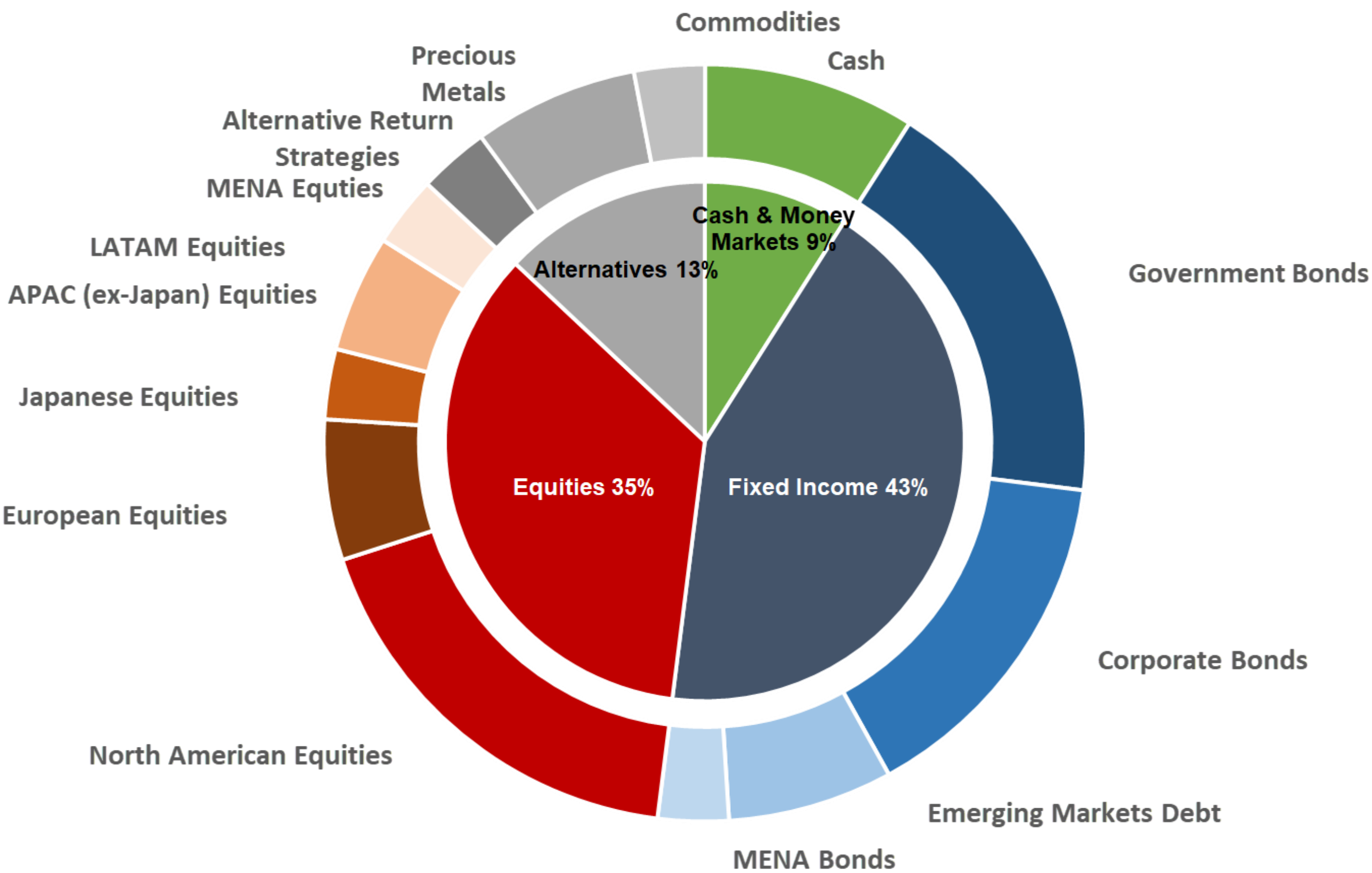
One month of lockdowns probably erased all the jobs created in the US since 2010

Without that agreement, oil prices could be looking at a further significant drop. Spot prices for Brent oil for delivery in Europe was already at US$26.3/barrel on Friday, 11.9% down on the week, while the nearest futures contract on the same quality of crude was at US$31.48/barrel.

Investors must remember that some of the most impressive rallies can be seen during bear markets, and most analysts are still attempting to come to grips with the extent of falls seen until a few weeks ago.

The extent of the bounce seen since then, and in the face of such dire economic metrics, suggests that caution should remain the watchword for the time being. It is encouraging that global financial authorities have been prepared to throw such huge amounts of cash at the collective problem. The question, however, is just how much of that cash will stick.

Current Tactical Asset Allocation



Asset Class	Positioning	Detail
Cash	Overweight	After taking profits on some equity positions.
Fixed Income	Overweight	Keeping slightly overweight focused on EM dollar debt and corporate investment grade bonds
Equities	Underweight	After taking profits on part of the US and European equity exposures
Alternatives	Underweight	However, overweight on precious metals specifically

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