Investment Strategy Update

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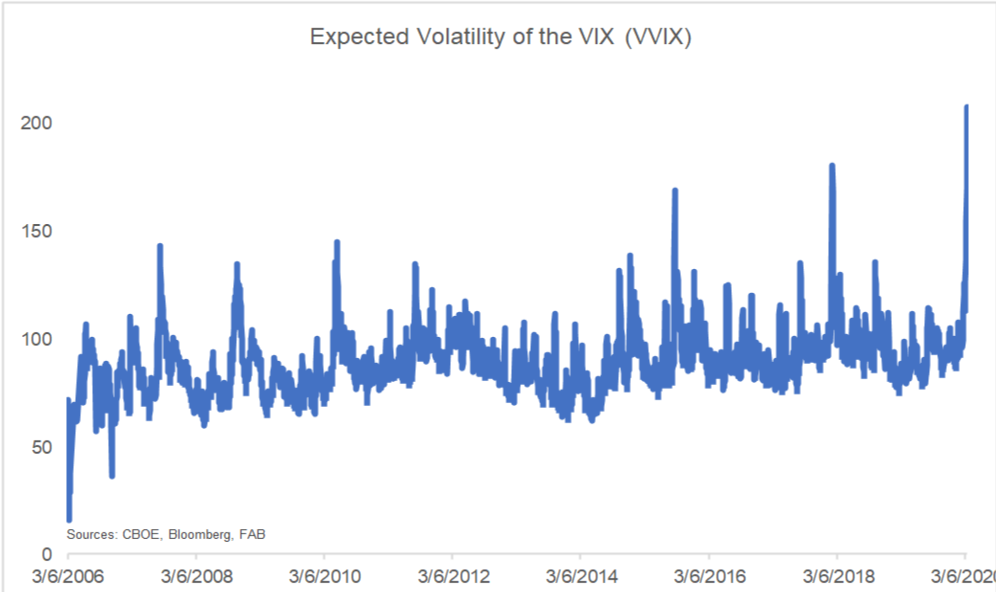
Trillions of stimulus pledged, but volatility spiral continues

- **Germany pledges US$600 billion, UK, US$420 billion and US up to US$1.2 trillion to combat virus-driven economic slowdown.**
- **Federal Reserve creates special programs to support the commercial paper market and to lend directly to primary dealers.**
- **Central bank intervention helps Treasury yields increase and corporate spreads start to stabilize.**
- **Abu Dhabi, Dubai, Singapore and Hong Kong among stock markets now trading below book value.**
- **Stock markets, however, continue to drop as some investors are forced to liquidate positions.**
- **FAB AAC remains underweight in equities and overweight in gold.**

It is war. While the terms were used by both the French and British governments to express their response to the global slowdown being caused by the new coronavirus, the US Federal Reserve has been, perhaps, the most diligent soldier.

Yesterday, Europe, the UK and the US unveiled more stimulus measures adding up to trillions of dollars. Still, the Fed's intervention was perhaps the most effective in bringing the first signs of normalcy to the market. The Fed created a new commercial paper funding facility as the three-months spread of short-term corporate debt in the US shot up to 144 basis points from less than 1 basis point two weeks ago. This threatened to close a key source of working capital in the US and prompt further economic deterioration.



The Federal Reserve also announced it was offering direct loans to primary dealers for up to 90 days. This measure helped the yield on 10-year US Treasuries to increase 38 basis points to 1.1% at the time of writing from the 0.72% at which it was trading on Monday. Part of the reason why Treasuries had rallied so much was because of regulatory liquidity needs of primary dealers, which was creating extra demand for these securities.

The move higher in Treasury yields is important as it also helps to start normalizing corporate bond spreads. The spread on the Bloomberg Barclays High-Yield index hit 846 basis points yesterday, the highest since 2011, during the European debt crisis. That was a sharp move higher from the 320 basis points spread at which the index started the year, and reflects expectations of a rise in the number of defaults this year.

The Fed's measures, however, have not been enough to normalize the stock market, which continued to swing wildly. The S&P 500 rose 7% during the US session, reflecting the better sentiment around stimulus and the Fed's intervention. However, S&P 500 futures were down by 3.8% as of writing, indicating there could be another sell-off in the US stock market today.

As long as the volatility of the VIX remains near a record, stocks may continue to suffer

In fact, the volatility of US stocks shows signs of large positions being liquidated. The last time the S&P 500 had so many 9% daily moves was in 1930, during the crash. While the stimulus being thrown at the world economy will reverse these drops at some point, for now it seems like the deleveraging spiral could continue for a while. Until this process of deleveraging is complete and volatility subsides, it may be dangerous to buy more risky assets.

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