Investment Strategy Update

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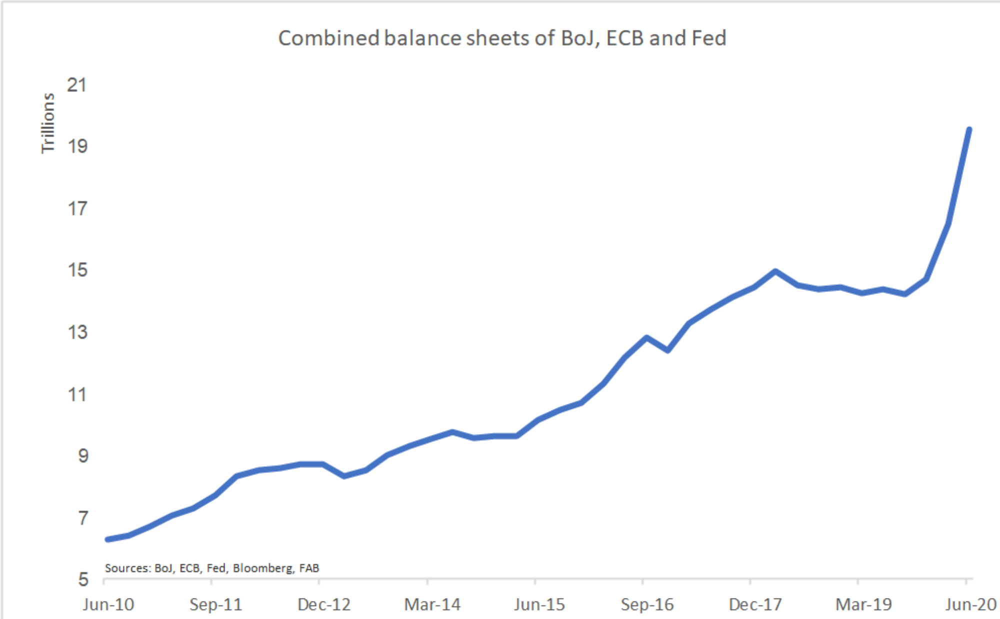
BoJ and Fed tell the world they still have money to pass around



- ♦ **Federal Reserve committed to buy investment grade bonds directly yesterday, helping to send markets soaring again.**
- ♦ **This morning the Bank of Japan increased its special lending program to 110 trillion yen (US$1 trillion) from 75 trillion yen.**
- ♦ **President Donald Trump's team is said to be planning a US$1 trillion infrastructure program.**
- ♦ **Second wave worsens in China, though, and tensions increase in the Korean Peninsula.**
- ♦ **FAB AAC remains overweight high quality investment grade bonds.**

Did you like what the central banks offered markets since March? Not to worry, there is plenty more where this came from. That seems to be the message that the Bank of Japan and the Federal Reserve sent to markets in the past 24 hours.

Yesterday, after a down day in European and Asian markets and as US stocks swayed, the Federal Reserve announced that it would start buying a broad and diversified portfolio of corporate bonds, extending a program that was previously limited to exchange-traded funds. As a result, the S&P 500 ended 1.3% higher.

A few hours later, the Bank of Japan doubled down on the additional stimulus by saying that they would increase their special lending program to 110 trillion yen (US$1 trillion) from 75 trillion yen. This announcement boosted the Nikkei 225 Japanese stock index by 4.9%, and the Kospi Korean index by 5.3%.

The Korean move was perhaps the best example of how the central bank stimulus has helped to boost risk assets. The reaction to the additional program from the BoJ trumped the negative undertone that may have otherwise tainted that market as tensions with North Korea increased. This morning South Korea confirmed that Pyongyang had blown up the inter-Korean liaison office on the northern side of the border between the countries.

Similarly, the US and European rallies were happening despite a worsening second wave of coronavirus infections. Beijing closed more markets today as it battled a new outbreak of the virus. The Chinese capital was shutting residential compounds where new cases were identified, avoiding for now a full lockdown of the city as it did in Wuhan in February.

In the US, new cases increased in several states fuelling fears that a full-blown second wave could soon hit. Indeed, epidemiologists warned that it takes about two weeks for the infections to manifest themselves in symptoms. Assuming that some of the protests and riots in the US over the past two weeks accelerated the spread of the coronavirus, the numbers would start rising towards the end of this week or the beginning of next week.

The BoJ, the ECB and the Fed have injected US$5 trillion into the economy since March

In short, there is plenty of reason to be fearful. On top of that, the valuation of some risk assets, such as stocks, is near all-time highs by some measures. These would be reasons to be cautious about risk. However, as the Fed and the BoJ have shown, whenever financial conditions get tighter, central banks will step in. The best advice right now seems to be, therefore, to just follow them.

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First Abu Dhabi Bank

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The Fed is buying fewer US Treasuries as more are being sold

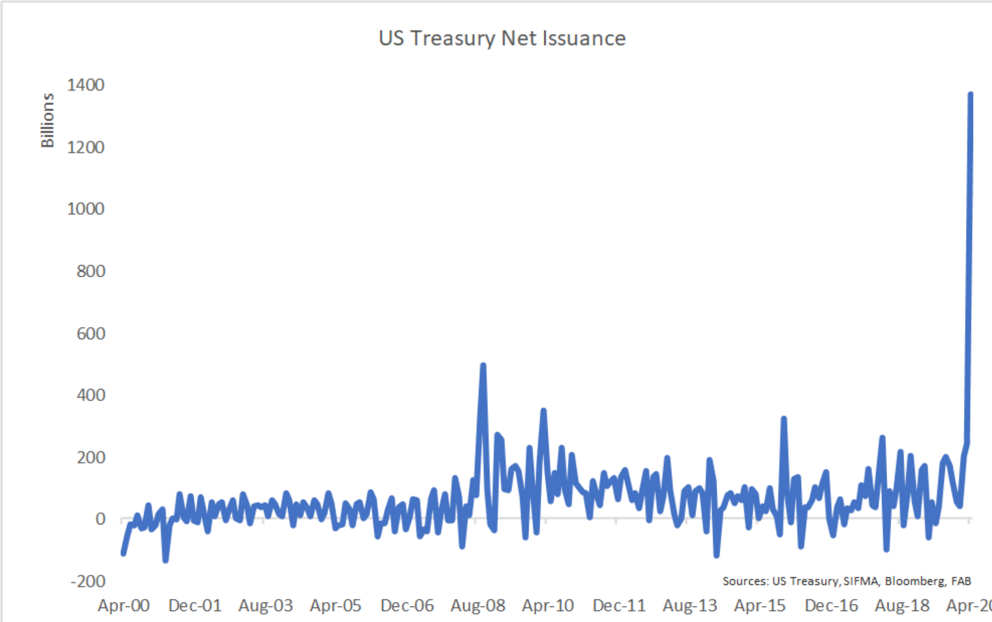
♦ The Federal Reserve has indicated it will reduce the pace of asset purchases after adding US$3 trillion to its balance sheet in three months.

♦ The central bank committed to buying at least US$120 billion a month of US Treasuries and mortgage-backed securities.

♦ Average mortgage-backed security issuance in the past three years has been US$175 billion a month.

♦ The US Treasury issued a record amount in April, with a lot more to come as stimulus programs are funded.

♦ FAB AAC remains overweight high quality investment grade bonds.



The Federal Reserve in not "even thinking about thinking about raising interest rates." That sentence, uttered by Chairman Jerome Powell, perhaps, is the summary of yesterday's Federal Open Market Committee meeting conclusion. Despite the promise of low rates for a very long time, the market started a minor correction yesterday that seemed to continue today.

News outlets sought a narrative in the economic projections of the Fed governors, which showed a much longer road to recovery than is perhaps priced into the market. The median projection of Fed economists showed the US economy not going back to its current level of output until the end of 2022, with a 6.5% contraction for the full year of 2020. The Fed sees unemployment remaining at 9.3% and to still be at 5.5% by 2022. That would entail a level of demand destruction which may not be fully priced into stock prices right now.

There was some mention too of concerns related to a second wave of infections as the number of people diagnosed with the Covid-19 virus took a turn for the worse in several US states which have started to reopen their economies. Texas reported 2,504 new cases on Tuesday, its highest one-day total since the pandemic began, Florida reported 8,553 new cases last week, its largest number in a seven-day period and California saw the highest number of hospitalizations since 13 May. To be sure, the increase also comes as most states have ramped up testing, still that could unsettle some investors.

Investors could also be focusing on the fact that going forward the liquidity injection may not be enough to make up for the amount of debt issuance coming up as a result of fiscal stimulus. In April, the US Treasury sold a net US$1.37 billion of new notes, the highest monthly amount in history. That happened as the Fed was buying up to US$75 billion of Treasuries a day, outpacing issuance. So the net result was more money going into the system even as there was more debt.

The US Treasury issued nearly US$1.4 trillion of debt in April, a record, with more to come

The Fed has, however, been slowing the pace of its bond buying, though Chairman Powell committed to continue to buy at least US$80 billion of Treasuries and US$40 billion of mortgage-backed securities a month. The average issuance of mortgage-backed securities over the past three years is US$175 billion and the US Treasury still needs trillions in funding. If the Fed is not buying those bonds, money will have to leave other assets to buy them. Perhaps, that is starting unsettle some investors. In any case, if it gets too bad, the Fed will come to the rescue.

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