

# ING's Covid-19 roundup: Lagarde and Powell's whatever-it-takes moment

The Fed's Powell didn't sugarcoat anything this week, but Lagarde's tone was much more measured. Both have been working hard to prevent credit nightmares, but our podcast highlights the ECB may start buying junk bonds too. As confidence builds Covid-19 curves are turning lower, we look at which currencies could lead FX markets through the recovery phase

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Snap | 30 April 2020

## ECB: Taking a short break without being breathtaking

ECB provides more, even cheaper, liquidity but keeps its QE dry. Suffice to say Lagarde is still trying to find her own fully convincing 'whatever...



Source: Shutterstock

### It was a bit as expected

The European central bank has decided to take a short break of reflection to take stock of all recent measures and their possible impact on the eurozone economy while turning some liquidity screws. Like everybody else, the ECB is also grappling to understand how severe the crisis actually is and how any recovery would look like.

According to ECB's president Christine Lagarde, the Bank has several scenarios (due to be published tomorrow) in which the eurozone could shrink by something between 5% and 12% this year. In the ECB's worst-case scenario, the ECB seems to assume that the eurozone could see an unprecedented hit of something like -15% QoQ in 2Q after today's -3.8% QoQ for 1Q20.

Nonetheless, there are still a few additional liquidity measures that the ECB decided on today:

- A cut of the interest rates on the targeted longer-term refinancing operations (TLTRO III),

from 25bp below the refi rate and 25bp below the deposit rate for banks reaching the 'lending performance threshold' to 50bp below refi and 50bp below the deposit rate. Together with last week's easing of the collateral framework, this should form what the ECB calls a 'liquidity backstop' and shows that the ECB can cut interest rates without cutting the policy interest rates.

- A new series of non-targeted pandemic emergency longer-term refinancing operations (PELTROs) to support liquidity conditions. These will be seven additional operations until September 2021, which will be carried out as fixed rate tender procedures with full allotment, with an interest rate of 25bp below the refi rate.

It is obvious the ECB is trying to support the eurozone economy mainly through ensuring there is enough liquidity and extremely favourable financing conditions for the banking sector, as this is key in providing credit to the real economy.

## No changes to PEPP....yet

With regards to all other instruments, there were no changes today but Lagarde extensively tried to stress her new version of 'whatever it takes', i.e. the ECB is 'fully prepared to increase the size of the PEPP and adjust its composition, by as much as necessary and for as long as needed.'

Lagarde said that the ECB would not accept fragmentation and that PEPP could be adjusted in terms of size and composition to ensure that monetary policy is transmitted to all sectors and countries. On OMT, interestingly, Lagarde performed a strange balancing act, which seems to indicate the ECB isn't really that keen.

## Key takeaways

- i) The ECB cannot walk on water, but it can keep interest rates unchanged and at the same time cut rates;
- ii) The main focus was on providing cheap and ample liquidity;
- iii) PEPP will be the main policy tool and there seems to be clear willingness to increase its size if need be.

## Comprehensible but not breathtaking

Lagarde is still trying to find her own fully convincing 'whatever it takes' moment. Today's decisions and explanations were all comprehensible but not breathtaking.

To give some credit, in the current situation and in the next phase when the eurozone economy enters the recovery, the ECB will not be in the driver's seat, fiscal policy will have to do the heavy work. The ECB can only provide financing power for governments and companies.

Unless the ECB follows up on its claim - as was heard multiple times today - supporting households and firms in the eurozone. But this would require launching the helicopters.

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# EUR & ECB: Mixed impressions but no risk premia build up

The newly announced and signalled ECB measures should help contain the EUR risk premium, with the missteps of the ECB March meeting not repeated. We...



ECB President, Christine Lagarde, pictured in February

## Sufficient measures but less conviction

In our [ECB & EUR Preview](#), we focused on two aspects of today's ECB meeting when it comes to the EUR/USD price action: (1) The potential top-up of the Pandemic Emergency Purchase Programme (PEPP); and (2) President Lagarde's communication. Although the former was stronger and more convincing than the latter, the EUR/USD should still be heading higher into the summer months :

### 1 Measures announced or signalled

President Lagarde hinted that the PEPP programme will be extended (as we and the market expected). Moreover, to ease the strains on the economy (as well as the banking sector) the ECB introduced a new series of non-targeted pandemic emergency longer-term refinancing operations (PELTROs) and changed conditions to TLTRO III – both being generous in availability and cost (see [ECB Review](#) more for more details). At face value, the ECB measures successfully contain any build-up of fiscal risk premium into the euro

## Press conference

While President Lagarde avoided the missteps of the March ECB meeting (which led to the sell-off in BTPs and, based on our estimates, translated into around 2% risk premium built up into the euro), at times the very repetitive press conference appeared to be missing the degree of conviction and the “whatever it takes” attitude markets might have hoped for.

## Risk premium unconstrained euro heading to EUR/USD 1.15 this summer

Looking beyond the short-term price action, we retain the view that the euro risk premium and the risk of a bloc’s fiscal crisis should not be a theme and driver of the common currency this year (the latest ECB measures increased our conviction). This should allow EUR/USD to appreciate in the coming months and reach 1.15 in the summer once the anticipated USD weakness kicks in. As we highlighted in [The FX road to recovery](#), USD screens as the least attractive G10 currency to position for the post Covid-19 recovery in global growth and easing of the lockdown measures. Coupled with the lost interest rate advantage and the large Fed's balance sheet, the dollar decline should facilitate higher EUR/USD.



# The FX road to recovery: Which currencies to back on the path out of lockdown?

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## Market confidence slowly improves

The length of lockdowns and the investment outlook are inextricably linked. The length of the lockdown determines the size of the economic contraction – particularly in 2Q20 – and the impact on corporate earnings profiles.

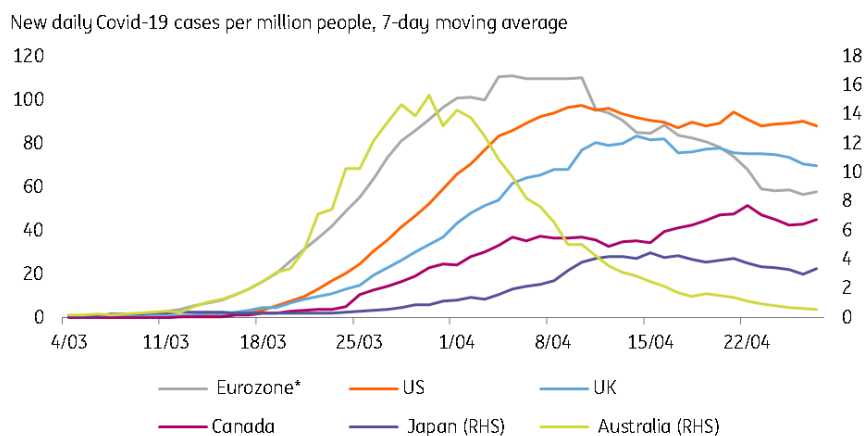
Markets are therefore welcoming the turn lower in Covid-19 curves and plans to re-open closed economies. These, along with the aggressive action of global policymakers, have combined to drag gauges of financial market risk further away from their peaks in March. Volatility levels are declining across the board and the USD Libor-OIS spread, a metric of inter-bank funding stress, is now at levels not seen since early March.

These developments will mean that in the FX space investors will be starting to re-assess their positioning. In particular, do conditions still merit holding the highest cash ratios since 2001 – that cash typically parked in near zero-yielding US Treasury bills?

With this question in mind, we've put together a FX scorecard for both the G10 and

emerging market currencies. This shows the factors we think are important and how currencies rank on each of those factors.

**Fig. 1 - Covid-19 contagion has slowed in major economies**



Source: Bloomberg, ING

## Putting together a FX scorecard

In selecting factors for our scorecard, we're incorporating the assumptions from our [April monthly update](#) of a U shaped recovery. Putting a letter on a uniform recovery is far from perfect and clearly other factors can be selected and weighted depending on one's views. But we think, some of the most relevant factors for FX market now should be:

1. **Valuation:** Cheaper currencies should be favoured because if the environment turns negative, a valuation premium will be welcome. We use a BEER model to estimate the mis-valuation of each currency versus the USD.
2. **Real rates:** In a world of zero/negative yields, investors will be seeking decent returns as sentiment stabilises. We calculate real rates as the policy rate minus the latest annualised inflation figure.
3. **Correlation with US yield curve:** If we are very slowly moving into a recovery stage, one might expect the US yield curve to start to steepen as optimism unfolds. We particularly look at parallels with the March 2009-March 2010 yield curve steepening. In our scorecard, we take the correlation of each currency with the US 10Y-2Y rate differential in that window.
4. **Exposure to oil markets:** Rather than looking at current account balances, which could mistakenly favour the oil exporters, exposure to oil exports will be a burden into the summer, and we would want to avoid these. [In this podcast](#), our Head of Commodity strategy explains why the oil crash may not be over yet. The measure we use in our scorecard is the latest available data on net crude oil exports as a percentage of GDP.
5. **Sovereign ratings:** A conservative approach to risk would also favour those sovereigns at the higher end of the ratings spectrum. We think this issue is more relevant for EM and less so G10, the latter group being more able to issue debt in their own currencies. For the sake of our analysis, we've assigned a numerical value to S&P sovereign rating scores.

All numbers are expressed in z-score terms for normalisation purposes. The scorecard aggregates

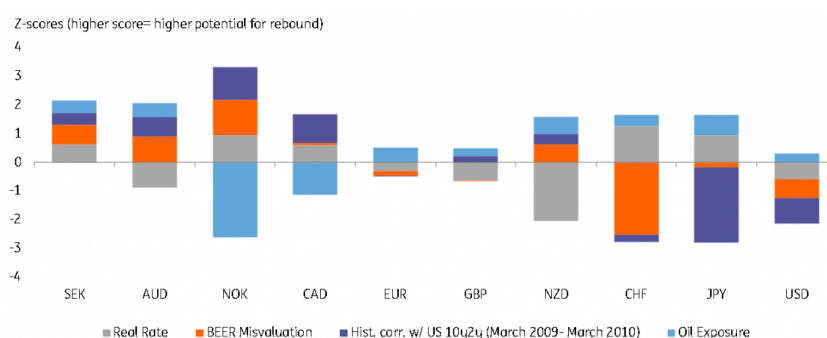
each factor's z-scores. When Eurozone-aggregated numbers were not available, we computed the GDP-weighted average of eurozone countries. For net oil exports, the eurozone value is a sum of Germany, France, Italy, Spain and the Netherlands.

We acknowledge that different lockdown measures will inevitably be key to determining how deep the recession will be in each country and ultimately have an impact on the respective currencies in the coming months. For this purpose, we looked at two potential measures to include in our analysis: a) Google's Covid-19 Community Mobility Reports, which shows how much visits to certain places (such as shops, workplaces) and help gauge the disruption caused by the lockdowns in each country; b) Oxford's Stringency index, which gauges how stringent lockdown measures have been in different countries.

We chose, however, to exclude these factors from our analysis as they don't factor in the announced "exit plans" to the ongoing lockdowns. How gradually an economy will allow people's movement again and what businesses will be allowed to re-open is surely going to drive most of markets expectations on each country's recovery from the shock. Without this information embedded in the data, the results could be misleading.

[Read Eurozone lockdown live: The risk of an asymmetric recovery here](#)

**Fig. 2 - G10 FX scorecard**



Source: ING, Bloomberg, IEA

## G10 FX: SEK and AUD may be the out-performers, \$ looks vulnerable

Based on our scorecard, some of the pro-cyclical currencies which don't have exposure to the oil market look as though they may lead FX markets through the recovery phase.

The SEK and AUD are both under-valued on our medium-term valuation model, are positively correlated with a steeper yield curve in a recovery phase and aren't saddled with exposure to oil.

AUD has already pared most of its 1Q losses and relatively strong fundamentals should allow it to keep leading any additional risk recovery in G10.

Here are the key points in favour of AUD: (a) the Australian government has stepped in with a massive AUD 320bn (around 16% of GDP) relief package; (b) as shown in Figure 1, Australia has been particularly successful in flattening the contagion curve; (c) Australia's biggest export, iron ore, is proving particularly resilient thanks to relatively stable demand from China and lingering

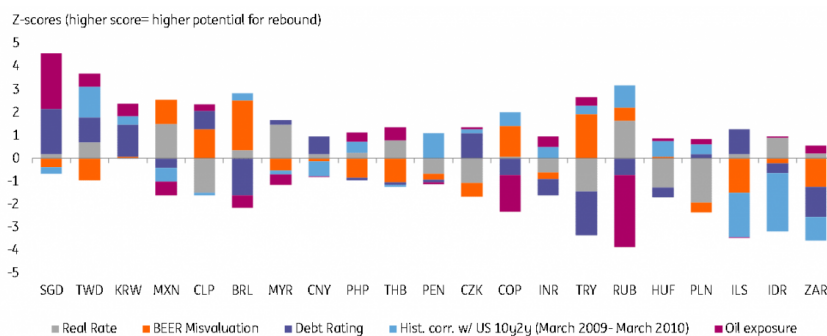
supply shortage from Brazil; (d) the central bank has already started some tapering and may be one of the first ones to lift stimulus measures as the global economy recovers.

*The SEK and AUD are both under-valued on our medium-term valuation model, are positively correlated with a steeper yield curve in a recovery phase and aren't saddled with exposure to oil*

The tide has also turned for SEK in our view as (a) the Riksbank has lagged its cyclical G10 peers on the easing front (no rate-cuts, only an extension of QE), which in turn materially narrowed the SEK negative rate differential versus its peers; (b) the lack of SEK exposure to commodity prices. This makes SEK well-positioned for a cautious recovery in sentiment towards G10 currencies in coming months and the currency screens as the most attractive in the G10 FX space. SEK should also benefit from the anticipated EUR/USD recovery more than some of its G10 peers.

Consistent with our views that the dollar will underperform during a recovery phase, our scorecard shows the dollar performing poorly in valuation, real rates and yield curve steepening episodes. The EUR appears mid-table and it seems unlikely to lead pro-cyclical currencies higher at the moment. The JPY does not score particularly well, largely weighed by the steeper US yield curve and US yields leading USD/JPY higher – yet we may be attaching too much weight to this factor if the Federal Reserve keeps US Treasury yields low to allow cheaper financing of ballooning government debt.

**Fig. 3 - EM FX scorecard**



Source: ING, Bloomberg, IEA, S&P

## EM FX: Better rated Asian FX may start to perform better, high yielders still vulnerable

When adding in sovereign debt ratings to the scorecard, Asian currencies move up our rankings. Here, Singapore is AAA-rated, while Taiwan and Korea are AA-rated.

Speaking to our Chief Asian economist, Rob Carnell, about top-ranked Asian FX he prefers KRW and TWD over the SGD. Korea and Taiwan look to have relatively better economic trajectories as exit strategies unfold. SGD gains may also be held in check by the managed FX regime, heavily weighted against the CNY. He agrees that the INR and IDR should be towards the lower end of our

table, especially in light of how local authorities are handling lockdowns.

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*Our Chief Asian economist prefers KRW and TWD over the SGD and thinks INR and IDR should be towards the lower end of our table especially in light of how local authorities are handling lockdowns*

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While the higher-yielding MXN and BRL appear in the better half of our scorecard, we would handle these currencies with caution. [Mexico stands to suffer the severest slow-down in Latin America](#) and it looks as though Banxico is now ready to favour growth over currency stability. Equally, [President Jair Bolsonaro's handling of the economy and cabinet departures](#) have added a political risk premium to the BRL, which may remain embedded during 2Q20.

In the EMEA space, the ZAR scores poorly on most metrics (including surprisingly on valuation) and we would like exposure in RUB, were it not for oil prices. RUB should nonetheless be the outperformer among the high yielding EM FX given the mix of high real rate, relatively solid fiscal stance and stable politics. All this, in one way or another, differentiates RUB from the likes of ZAR, TRY, MXN or BRL.

Within the CEE FX space, CZK looks the most appealing given its strong fiscal dynamics, no quantitative easing from the central bank (versus QE in other CEE countries) and the “CNB put” placed under CZK given the bank’s high FX reserves. We see PLN as the least attractive CEE currency at this point due to its most negative real rate in the entire EM space and the large scale central bank QE - around 8% of GDP.

## Key Takeaways

- We prefer G10 over EM, at least in the early stage of the recovery, where the sovereign balance sheet will be important.
- Within G10, we look for out-performance of SEK and AUD – largely at the expense of the dollar.
- Within the EM space, it looks too early to expect a sustainable bounce in the high yield space (we prefer G10 commodity FX over EM commodity FX). And north Asian FX (KRW and TWD) look best placed to take advantage in any global rebound.

For reference, all our latest FX views and forecasts can be found in the [April edition of FX talking](#).

[FX Talking: Finding currency strength amid the crisis](#)

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## Watch: 6 ways Covid-19 is transforming digital finance

The coronavirus pandemic is hitting global economies but it's also having unforeseen impacts on the evolution of digital finance. Here's how

#5 change



new attention to inequality



and uneven access to financial services.

### 6 ways Covid-19 is transforming digital finance

The Covid-19 pandemic is having a profound and lasting effect on digital finance. So says ING's Teunis Brosens who's been looking into areas which are now undergoing major change. Big tech firms are in the spotlight like never before. As more of us work from home, we better appreciate the importance of a safe and reliable digital infrastructure; cyber security is moving up the policy agenda. Contactless payments are replacing physical cash. With the coronavirus also leading to uneven access to financial services, we see that data may play a pivotal role in controlling the virus' spread.

[Watch video](#)



Snap | 30 April 2020

## US: 30 million jobs lost

Another 3.839 million people filed a new unemployment claim last week bringing the total jobs lost to 30.3 million since mid-March. With a further third...



**30.3mn** New jobless claims in past six weeks

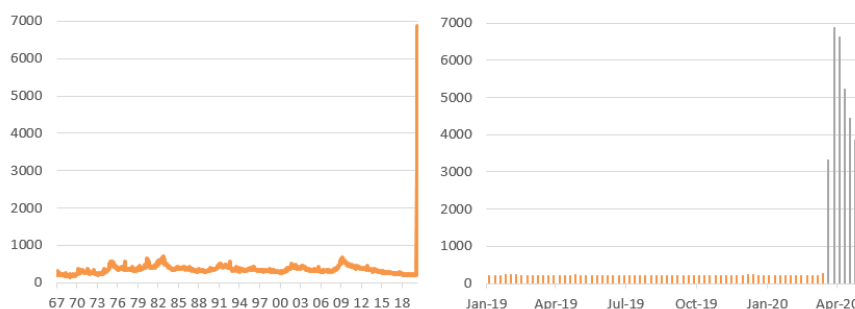
### Yet another grim day for the household sector

Initial jobless claims for the week of 25 April were 3.839 million versus the consensus forecast of 3.5 million. This is the fourth consecutive slowing in the pace of new jobless claims, but it is still horrible and underlines the severe economic consequences of the Covid-19 containment measures. More than 30 million jobs have been lost since mid-March and many more are set to follow as companies across all sectors in the economy feel the strain of the collapse in demand.

It is clear that while the initial wave of job losses were concentrated in retail and hospitality due to the shutdowns, they are spreading to suppliers and to other industries. Terrible manufacturing surveys point to job losses – tomorrow's ISM survey will likely break through the lows of 12 years ago – and the business service sector is certainly not going to be immune.

Furthermore, the re-opening of some states, including Georgia, Tennessee, South Carolina and Florida, appear to have gone fairly slowly. Consumers remain reluctant to go shopping or visit a restaurant due to lingering Covid-19 fears, while the social distancing restrictions placed on the number of customers allowed in restaurants do not make it economically justifiable for some to open. Evidence so far suggests very little chance of a V-shaped recovery, meaning that unemployment is unlikely to come down anywhere near as quickly as it has been going up.

## Weekly initial jobless claims (000s)



Source: Bloomberg, ING

## Next week's jobs report

The April jobs report is published on Friday 8 May, but we have to remember the data is collected in the week of the 12th so today's numbers will actually be more applicable to the May jobs report, published in early June.

If we assume unemployment has risen 20 million in April, that would push the unemployment rate to around 16%. An additional 10 million unemployed in May and we are looking at an unemployment rate of around 22%. Thankfully, this is below the 24.9% peak experienced in 1933, but we have to remember that one third of Americans aged 18-65 are not classified as employed or unemployed – they are students, early retirement, homemakers, carers or sick.

This leads us to yet another sobering statistic – that less than half of working age Americans will be earning a wage next month. In an election year, this means that the call for politicians to re-open the economy is only going to get louder, irrespective of the health advice.

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Podcast | 1 May 2020

# Listen: Fallen angels - The devil in disguise?

The European Central Bank could soon join the US Federal Reserve in buying bonds recently downgraded to junk status. But with default rates over the...



## Risky business

Unlike the Federal Reserve, the European Central Bank has not yet discussed adding junk bonds to its asset purchase programme. But President Christine Lagarde has signalled that this option is very much on the table. [In this podcast](#), ING's Global Head of Sector Research, Jeroen van den Broek, tells Senior Editor Rebecca Byrne why he thinks the Bank will end up buying high yield debt, and what the consequences of this decision could be.

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Article | 29 April 2020

## US GDP: The descent begins

After a strong January and February, a combination of Covid-19 containment measures and consumer fear meant activity collapsed in March. With lockdowns...



Source: Shutterstock  
New York

**-4.8%** 1Q annualised GDP growth

### Slamming on the brakes

At the start of the year the US economy was in great shape. The uncertainty from US-China trade tensions was lifted by the deal signed between Presidents Trump and Xi while the lowest unemployment rate for over 50 years looked set to propel consumer spending ahead strongly. In fact, the Atlanta Federal Reserve Bank's GDPNow model, based on data released for January and February, suggested the US was on course for 4% annualised growth in the first quarter.

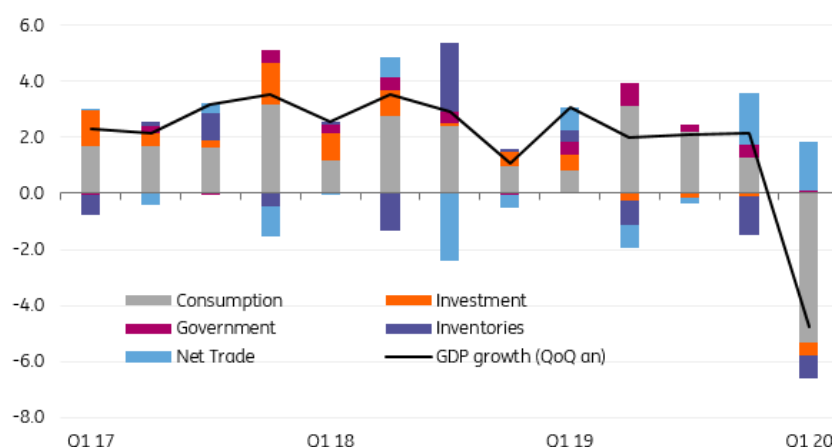
Instead, today's GDP report confirms that the mid-March lockdowns that shut businesses and to date have seen 26.5 million Americans lose their jobs, crushed economic activity in the final few weeks of March. Today's 4.8% annualised GDP contraction is the worst reading since 4Q 2008 and

the depths of the financial crisis (-8.4% annualised).

The details show that household consumption was the weakest area, falling 7.6% annualised. We had already seen retail sales fall 8.7% month-on-month in March, with expenditure on hotels and travel falling even more. Business investment also fell (non-residential fixed investment dropped 8.4%), despite typically long lead times between making a decision and the money actually hitting the ground. Inventories were run down and subtracted half a percentage point from headline GDP.

There were some positives though. Residential investment surged 21% while net foreign trade actually added a full 1.3 percentage points to headline growth as imports plunged more than exports. These strong positive contributions won't be repeated in 2Q. Rounding out the numbers, government spending rose at a 0.7% annualised rate.

## Contributions to US GDP growth



Source: Bloomberg, ING

## 2Q GDP to fall at a 40% annualised rate

While today's reading is bad, the 2Q report is going to be far worse. We have pencilled in a 40% annualised contraction (-10% quarter-on-quarter) which, following the 1Q fall (4.8% annualised is roughly 1.2% QoQ), means that US economic output will be down 13% peak to trough. This is on a par with the downturn experienced as World War II concluded, but that occurred over three years, not two quarters as is happening today.

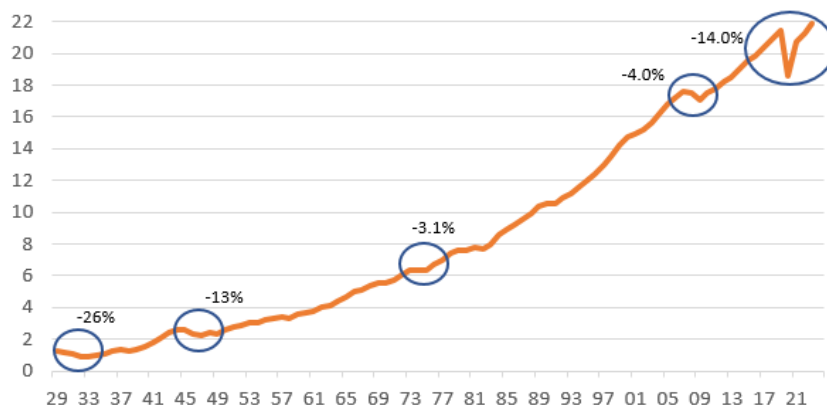
We must remember the lockdowns only really came into effect in mid-March, so total consumer spending through April will be well down on March. Even if we assume the bulk of the lockdowns start to ease from mid-May, ongoing social distancing, consumer caution and the legacy of 30 million unemployed Americans will ensure spending through June remains well down on the levels of January and February.

Travel restrictions will remain in place, limiting the scope for a recovery in the airline, hotel and hospitality industries while social distancing measures may make many restaurants and bars unprofitable and force their closure. With many businesses in different industries warning they will need to restructure, millions of people who have lost their jobs will struggle to find work quickly.

Investment, particularly in the oil and gas sector, will plunge in 2Q. Moreover, with

manufacturing output falling substantially, there is little need to invest in expanding production facilities. Export growth will be constrained by the gradual re-opening processes expected elsewhere.

## GDP levels since 1929 with major recessions & ING's forecast



Source: Macrobond, ING

## The long road back

Unfortunately, we doubt that the US will experience a V-shaped recovery. The legacy of the crisis and the potential for long term structural changes mean at best we currently think the lost output in 1Q and 2Q won't be fully regained until late 2022.

This is all quite gloomy, but with the Federal Reserve and the government continuing to offer support and with Covid-19 containment measures likely to ease further in the second half of the year – particularly if work on a vaccine makes substantial progress - the news flow for the economy should be much improved for 3Q and 4Q. To ensure we do regain the lost output by late 2022, an additional fiscal stimulus will be required and looks very likely. How that will be constructed (mix between spending and tax cuts) will be a key theme of the election battle between President Trump and his Democrat rival Joe Biden.

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## Federal Reserve: Delivering home truths

While equity markets are looking positively to the future, the Fed's downbeat tone offers a sobering assessment on economic prospects. Nonetheless,...



Source: Shutterstock

### No change as the Fed warns of "considerable risks" over the medium term

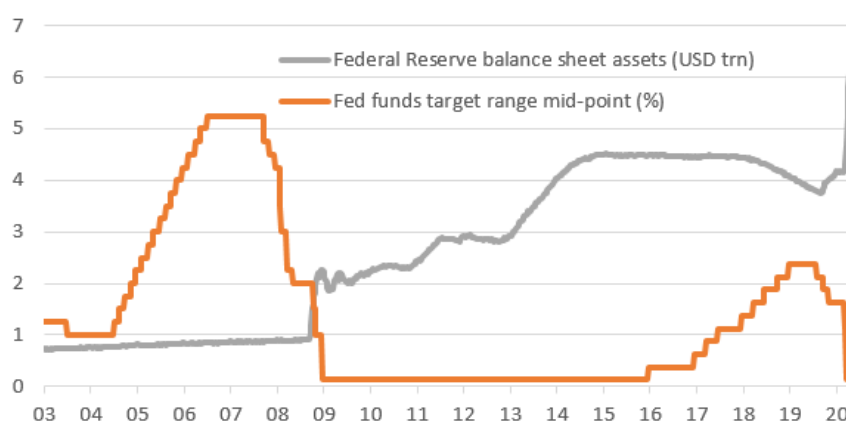
The Federal Reserve voted unanimously to leave policy unchanged with the target range for the federal funds rate maintained at 0-0.25% and the interest rate on excess reserves left at 0.1%. This will remain the case until the Fed is "confident that the economy has weathered recent events and is on track to achieve its maximum employment and price stability goals".

Officials have also promised to continue to "purchase Treasury securities and agency residential and commercial mortgage-backed securities in the amounts needed to support smooth market functioning".

The statement itself is downbeat, highlighting the "tremendous human and economic hardship" that the coronavirus outbreak has caused around the world. It also notes the significantly impaired financial conditions that have hurt the flow of credit in economies. This will "weigh heavily on economic activity, employment and inflation in the near-term and poses considerable risks to the economic outlook over the medium term".



## Federal Reserve balance sheet & policy interest rate



Source: Macrobond, ING

### The Fed still has more options... if needed

Improved financial market conditions have meant the Fed has started to slow the rate of QE purchases of Treasuries from an initial \$75bn per day to \$10bn per day.

*The Fed can also conceivably cut interest rates into negative territory, but we sense this would be very much a last resort option. The fact that Sweden didn't return to negative rates yesterday underlines this point*

Nonetheless, the press release emphasises they could be ramped up once again and that it has more in its toolkit should that be necessary. If the Fed felt more action was warranted to ensure recovery it would likely involve expanding current asset-buying programme volumes and broadening the range of assets included in its QE initiative.

It could also conceivably include cutting interest rates into negative territory, but given the limited success of these measures overseas, we sense this would be very much a last resort option. Sweden's decision not to return to negative rates yesterday underlines this point.

Moreover, the implications for money market funds and "breaking the buck" offers a strong disincentive to go down this route.

### A long unwind

The prospect of ongoing social distancing and travel restrictions over coming months in combination with numerous likely business failures means the recovery has little chance of being V-shaped (see our earlier [GDP note](#)). At the same time the risk of a second wave of Covid-19 once lockdown restrictions are eased, prompting a renewed economic downturn, cannot be ignored.

The Fed will, therefore, retain a desire to keep policy stimulative until there is the confidence that Covid-19 is beaten and the US economy is on a reliable and sustainable growth path.

*A move from the emergency zero percent level looks set to be many quarters and possibly even years away*

Given the scale of the economic downturn, which we think will be around 14% peak to the trough (between end 4Q19 and end 2Q20), we see very little near-term price pressure outside of areas such as food. A huge output gap with more than 30 million people out of work is not a recipe for higher wages and higher inflation in general.

Given this backdrop, a move from the emergency zero percent level looks set to be many quarters and possibly even years away. We suspect that the Fed will first bring about an end of their asset purchases, potentially in late 2020/early 2021. They will then maintain the size of the balance sheet for a period (depending on the pace of the recovery) and then our best guess at present is that they will start to contemplate rate hikes in late 2021/early 2022 with the balance sheet then allowed to start running down as assets mature.

Nonetheless, the risks remain skewed to a longer time frame for action.

Read

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## BoJ's "whatever it takes"

Markets rise on another "whatever it takes" - this time from the Bank of Japan. But is there any room for more?



Source: istock

### Glass half empty, cracked, with a dead spider in it

OK, I'm not known for my sunny disposition, but even I can see that yesterday's Bank of Japan (BoJ) "Whatever it takes" announcement could be viewed positively by investors in risk assets. That basically makes it all the big central banks. Smaller central banks also all seem to be doing about as much as they can, with a few more rate cuts from some still to come, and a bit more liquidity from RRR cuts mixed with a bit of financial forbearance on things like leverage ratios for banks (Bank of England's latest). But basically, the monetary spigots are wide open.

Just to briefly re-cap on yesterday's BoJ pledges. These amount to the following (my views in parentheses)

1. The current Japanese Government Bond (JGB) target of JPY80tr per year of outright purchases to be replaced by "unlimited" JGB purchases (yet the BoJ were not even needing to buy that amount in order to hit their zero % yield target for the 10Y JGB - so surely this is the removal of a non-binding constraint?)
2. A quadrupling of their corporate bond purchases (this is a bit more meaningful)
3. Enhance the "special funds" supplying operation. This includes: a) expanding the range of eligible collateral b) increase the number of eligible counterparties and c) apply a positive interest rate of 0.1% on balances held by banks corresponding to loans extended through

this operation.

For more detail, [here is the BoJ's own account of its enhanced measures.](#)

The final measure seems a bit of a hybrid of the Bank of England's funding for lending scheme, mixed with the Fed's Interest on Excess Reserves, and should help with corporate liquidity problems.

But, and I think it is worth returning to this, the BoJ's outlook for growth for 2020 is -3 to -5% (ING f -4.9% towards the bottom of this range) and the outlook for inflation is -0.7% to -0.3%. The outlooks for fiscal 2021 look fanciful and overly optimistic at 2.8% to 3.9% - basically saying that 2021 returns all the lost growth on top of the underlying growth rate for a net "no loss" position. That is basically nonsense. [See the BoJ's argument and make your own mind up.](#)

The BoJ's forecasts, I think, encapsulate what a lot of market participants are assuming about this crisis, which makes them blind to current bad news, but celebrate every positive policy response. And I struggle with this. I think they are assuming:

1. It will basically all be over by Jan 1 2021 (there's a lot of optimism in a vaccine)...
2. ...and no second wave, despite some questionable opening ups in some parts of the world, and still worsening case counts in others.
3. It will have left no residual damage, so output lost will be restored with pent up demand returning us to more or less where we would have been before

In short, a nasty, but temporary interlude from the prevailing growth trend.

All of these assumptions seem highly questionable to me. I would prefer a base pricing model that assumed the following:

- Some permanent and perhaps substantial loss of potential output due to business failures, in spite of Central banks best efforts
- Jan 2021 is not "business as usual, but some social distancing measures remain. International travel remains a shadow of its former self, consumer spending on services remains dampened, and manufacturing adopts new, clunkier and probably less efficient and less profitable (but safer) supply chains.
- This may also be wrapped up with a more nationalistic policy on supply, possibly tied around a flaring up of trade war issues once more.

So as I said, I can't blame the market for reacting positively to news like this, or indeed the continued progress towards re-opening. But for me, the present value of the future I see, does not warrant these levels. I'm not a buyer.

## Asia today

There's not much else going on today: Prakash Sakpal writes this on Thailand: "The Thai government is planning to extend its state of emergency by a month until 31 May. Meanwhile, the country's tourism authority has dashed hopes of a near-term economic recovery as it expects a 60% plunge in tourist arrivals this year with this, in turn, denting tourism income by at least half. All this adds to the downside risk to our view of a 7.7% YoY GDP fall in 2Q20 and full-year contraction of 4.3%. We expect an additional 50 basis point central bank (BoT) rate cut this quarter, taking rates to a record low of 0.25%, fueling the need for unconventional easing after that".

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## Federal Reserve: Coffee break for the plumber

Credit where credit is due, the plumbing job has been effective. Libor is down and continues to fall. Credit spreads have been contained. Last week the...

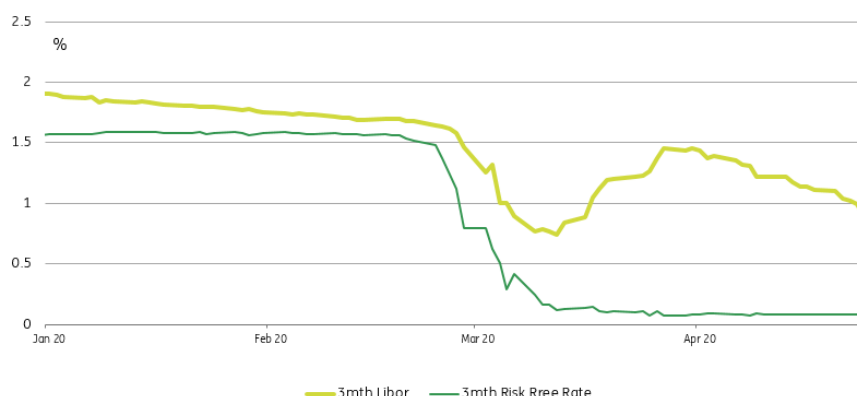


### The plumbing is working - Libor now below 90bp

The massive plumbing operation initiated by the Federal Reserve in the last few weeks has been reaping good outcomes.

The most striking evidence of this has been the fall in 3-month USD Libor. This had topped 1.45% at the end of March, at a time when the Fed had coaxed the risk-free rate down close to zero. USD Libor began to fall slowly at first but has more recently made more pronounced bounds lower. It is now below 90 basis points. In consequence, all loans and products linked to USD Libor have the capacity to see their rates fall too, and share the benefit from the lower Fed funds rate. That's the good news.

## Libor falls back towards the risk-free rate



The not so good news is that 3-month Libor is still some 80bp above the risk free rate. By way of a guide to a more normalised rate, the 5-year median spread between 3-month Libor and the secured overnight financing rate (Sofr) in arrears is around 27bp. The bottom line is, even at 80bp, dollar Libor is very elevated versus what could be considered normal.

This relative elevation on Libor reflects pressure on banks generally. Libor is, after all, the implied cost of funding for banks. The fall in Libor actually overstates improvement here, but credit here to the Fed's plumbing exercise that has facilitated the fall in Libor in the first place.

## A positive vibe in credits has helped - without the Fed's SPV, yet

One of the important background influences has been the wider credit market. Here there has been a material improvement in sentiment, from the functioning of the primary market to stabilisation in secondary market spreads.

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Remarkably, the Fed's SPV set up to buy secondary market corporate credit has not been put to much work, so far. The fact that it is has been there in the wings has been a clear positive though, as just the knowledge that the Fed has the firepower to buy secondary market corporate credit helps spreads through anticipation of future buying.

There has been some USD 34bn spent on primary market support, but this is down some USD 6bn from the previous week. At the same time paper held by the Commercial Paper Funding Facility at



the Fed is running at some USD 2.7bn, which is not a particularly high number. All in all, these data points gel with a less panicky set of circumstances.

## Other forms of help has been pared back, but don't extrapolate it

The support provided for money market funds has also been reduced, and this was an area of particular stress at the end of March as the implications of the shutdown for corporate America became more evident through stressed calls on such funds for emergency liquidity. Fed support through the Money Market Fund Liquidity Facility is running at close to USD 50bn but is down some USD 2bn in the past week. Even the support provided through the Primary Dealer Credit Facility is down some USD 4bn (to USD 31bn), again in tune with an easing of the exceptional support being shown by the Federal Reserve.

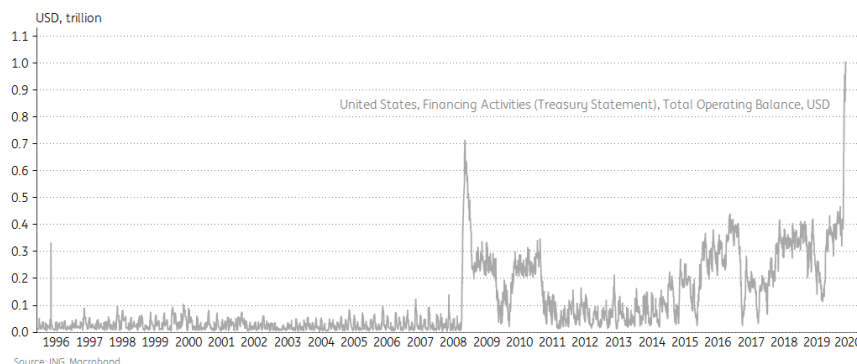
This is not to suggest that this is the beginning of a trend. Far from it. It should be seen more as an easing of the need for immediate emergency support, but against a big picture backdrop where the call for such support could well re-accelerate in the weeks and months to come.

We are in a period now where the apex of the infections rate curve is in the rear-view mirror, and extrapolation into the summer can paint a re-opening process that is credible. The problem is, the quality of that re-opening and risks beyond that (extending into an elevated default risk) will mean that exceptional Federal Reserve support will remain very necessary in the months ahead.

## And there is still a large hard bill to be financed by the US Treasury

The other important aspect for the rates markets is the cost of financing the macro shutdown. The Congressional budget office has set out a financing estimate in the area of USD 3.7 trillion, practically four times a more typically annual issuance requirement. So far the bulk of the pressure has been on the bills market, which has helped to build a USD 1 trillion Treasury cash balance. The extra issuance pressure will need to be filtered into longer duration product during future re-fundings.

### The biggest Treasury cash balance, ever



US Treasuries will continue to offer a robust off-set to default-risk impacted credit exposure, but expect bond prices to eventually fall to reflect the extra supply.

As the summer heats up and the immediate health crisis pressure eases back, investors will be asked to take down much more duration. Ultimately this will pressure rates higher. Not just yet though, as Fed buying plus robust investor demand still dominates.

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## Libor reform: Big bang moment(s) ahead

The big prep continues; for the day when we morph from Ibors to the holy grail of risk free rates. Slowly but surely progress is being made, but the real...



Source: Shutterstock

The big prep continues; for the day when we morph from Ibors to the holy grail of risk free rates. Slowly but surely progress is being made, and items are ticked off as complete. But the real deal is the moment when we make the switch(es), as we still have different agendas running at different paces. The deadline is end-2021 (albeit more relaxed for Euribor). It's a race, not to the finish, but to get ready.

At some point in 2021 there will be an announcement that Libor will cease to exist. Prior to that point, all ducks need to be in a row. We know now for example that the spread from Ibors into the respective risk free rates will be set as the 5yr median, for derivatives. For cash products this is supported by some working groups, but not all, at least not yet. There is also likely to be a

difference between the calculated median transitions spread and the actual spread. Also there are Covid-19 related delays to consider.

That said, and contrary to popular opinion, these strange times might just throw up a set of circumstances that maximise the odds of having a smooth conversion. Why? It is not inconceivable that one year from now we find that Libor has calmed to a more “normal” level, and that Risk Free Rates in arrears are flat to Risk Free Rates in advance, as official rates remain low and the forwards benign. If we get that, we could find, remarkably, that conversion rates are stable and close to historical medians.

But even before we get there, some important nuances are in play. US consumer loans will likely have a 1yr transition to the 5yr median spread. In contrast, typical derivative contrasts will likely gap to the new spread. Any deviations here could potentially be melted into an adjustment of credit spreads charged by banks, but this is open to question and far from certain. Important here is synchronicity between business loans and derivatives, else hedges uncover unnecessary basis risk.

Cross currency swaps is another areas of contention. While some consensus has built on convention for the mirrored Risk Free Rate swap, there is none on the re-papering of just one leg from Ibor; it's being left to the individual counterparties. Euribor will likely stay around a bit longer than Libor, increasing this risk. At the same time, the recent shutdown and systemic pressure on the Eurozone has pressured reformed Euribor more than is comfortable (therein, in fact, is a reason for Euribor to switch sooner).

Meanwhile, the UK continues to cheerlead the process. No more Libor-linked cash product after 3Q20 is the target, and the BoE will increasingly penalise Libor-linked collateral in its operations. They mean business in the land that first gave us Libor.

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