Situation Room

Cash is king

16 March 2020

Credit Strategy
United States
Cross Product

- **We published the latest Credit Market Strategist on Friday. Click The long and short of confidence shocks or see inside for the key bullets.**

- **Cash is king**. The impact of funding strains and the frozen commercial paper market is seen in the very front end of IG corporate bond market as spread curves are inverted. While normally spread curves invert due to credit risk, this time it is a liquidity story as investors raise cash and money market and other funds de-risk as they expect large withdrawals given the partial shutdown of the global economy. If the Fed soon intervenes to support the commercial paper market that would lead to some re-steepening of spread curves.

- **Worsening realized bid/ask in front end**. Quoted IG bid/ask spreads continued to widen through last week, while the realized average trading costs estimated based on TRACE declined Friday and today. Across the curve bid/ask spreads increased the most for short-term since the start of the current selloff.

- **Record IG outflows**. Friday saw a $10.8bn outflow from IG bond funds/ETFs.

- **Coronavirus tracker**. There are signs that the number of daily new COVID-19 cases in Italy is peaking around current levels of about 3,500. In Lombardy the number of new cases has declined for consecutive days. Defining Day 1 as when a country reached 40 Covid-19 cases, China reached its peak daily case count on Day 21, whereas two days ago in Lombardy was Day 23. A further 21 days later in China the daily case count had declined 90%. In the US today is Day 16, which means the potential for new cases to peak around this coming Sunday.

- **Drawing credit lines**. Nine more companies – AerCap Holdings, Micron, Carnival Corp, Anheuser-Busch InBev, Kraft Heinz, Air Canada, Caesars Entertainment, MGM Resorts, and Park Hotels – have announced intentions to draw down credit lines.

- **Final fund flows update for February 2020**. $16.5bn of net monthly inflows

- **TIC update for January**. Foreign investors net sold $30.7bn of US corporate bonds.

- **Daily credit snapshot**. No US IG new issuance today. Despite the Fed's 100bps rate cut and $700bn QE, equities closed down 12.0%, the Treasury curve bull-flattened, CDX IG widened 19.0bps, CDX HY dropped $4.60pts, and liquid cash bond spreads underperformed CDX trading 15-50bps wider on average on the day.

- Daily foreign demand tracker, CP / CD still frozen, BoJ review: everything but cuts, Fed: another 100 and QE, Sharp contraction in Jan-Feb China activity data.

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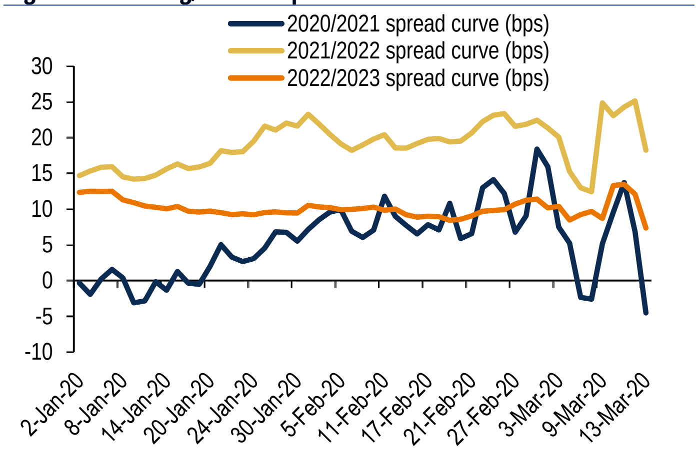
Research Overview — The Situation

Cash is king

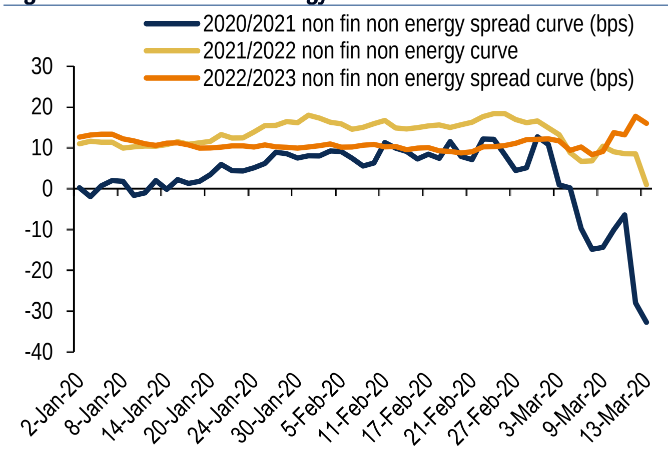
The impact of funding strains and the frozen commercial paper market is seen in the very front end of IG corporate bond market as spread curves are inverted (Figure 1). While normally spread curves invert due to credit risk, this time it is a liquidity story as investors raise cash and money market and other funds de-risk as they expect large withdrawals given the partial shutdown of the global economy. If our interest rate strategist, Mark Cabana, is right that the Fed soon intervenes to support the commercial paper market that would lead to some re-steepening of spread curves and outperformance in the very front end of the curve.

Figure 1: Flattening/inversion pressures in front end of the IG curve ...



Source: ICE Data Indices, LLC

Figure 2: ... ex. Finance and Energy



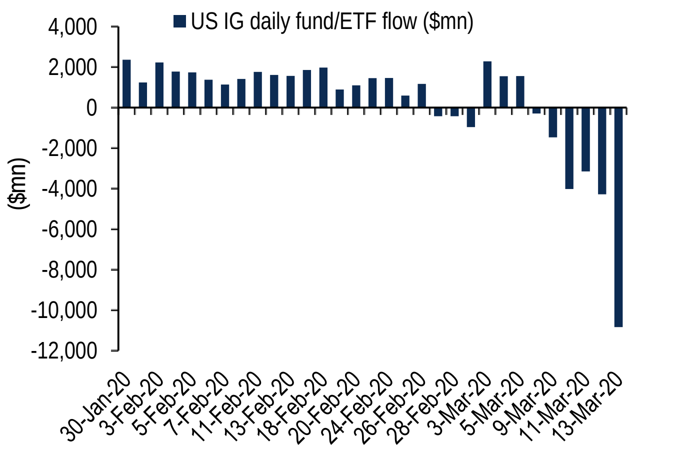
Source: ICE Data Indices, LLC

Credit Strategy

Record IG outflows

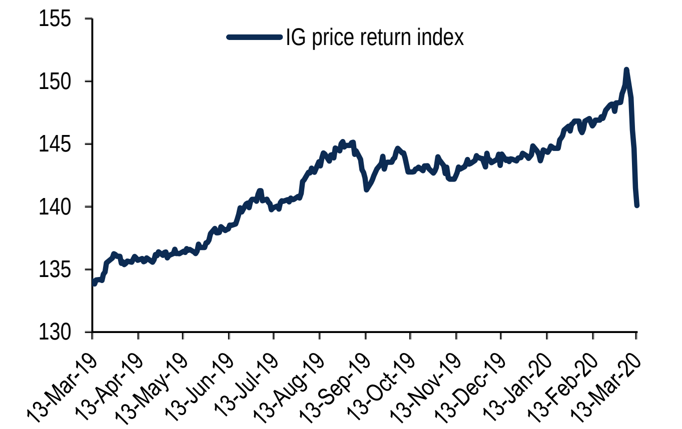
Friday saw a $10.8bn outflow from IG bond funds and ETFs (Figure 3), the largest on record, driven in part by last week's off-the-chart 7% decline in bond prices (Figure 4) as flows tend to follow returns. However included in our sample are short term and total return bond funds and it is plausible many investors are forced to draw on them as the economy shuts down partially.

Figure 3: Record daily outflow from IG bond funds and ETFs on Friday



Source: Epfr Global

Figure 4: Driven in part by last week's 7% decline in bond prices

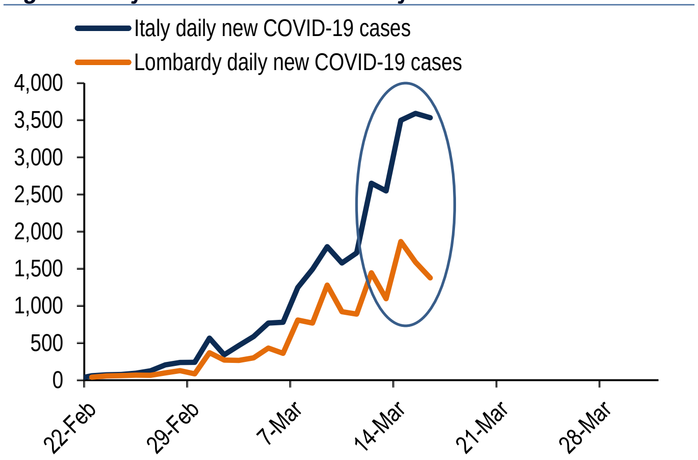


Source: ICE Data Indices, LLS

Coronavirus tracker

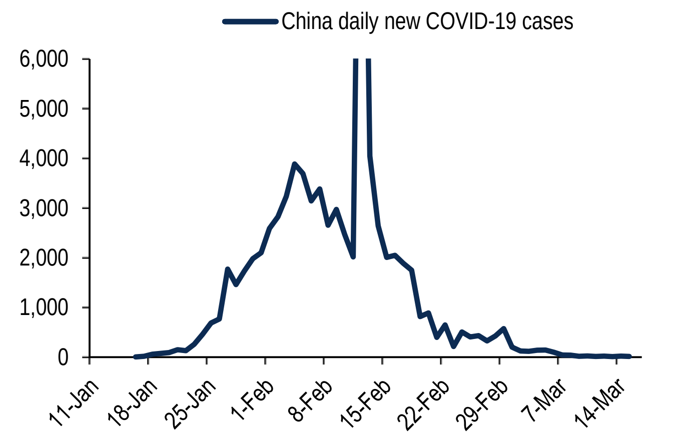
There are important signs that the number of daily new COVID-19 cases in Italy is peaking around current levels of about 3,500. In Lombardy the number of new cases has declined for consecutive days (Figure 5). Defining Day 1 as when a country reached 40 Covid-19 cases, China reached its peak daily case count on Day 21 (Figure 6), whereas two days ago in Lombardy was Day 23. A further 21 days later in China the daily case count had declined 90% from peak levels. In the US today is Day 16, which means the potential for new COVID-19 cases to peak around this coming Sunday, should the patterns from China and Italy be replicated here. The timing of Italy and the US taking dramatic actions to shut down the countries was at nearly identical stages in their outbreaks. Three weeks after that is April 12th. US cases meanwhile are tracking 4,138 as of this writing, or less than the average number in other outbreaks including Italy (Figure 7).

Figure 5: Daily new COVID-19 cases in Italy



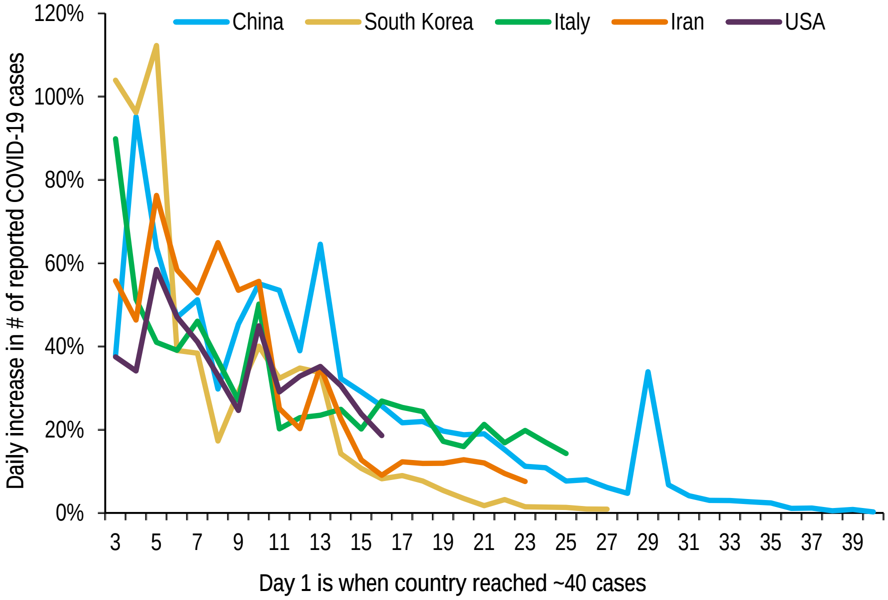
Note: Made upward adjustment to Italy's numbers for today as two regions did not report
Source: Bloomberg., Johns Hopkins, BofA Global Research

Figure 6: Daily new COVID-19 cases in China



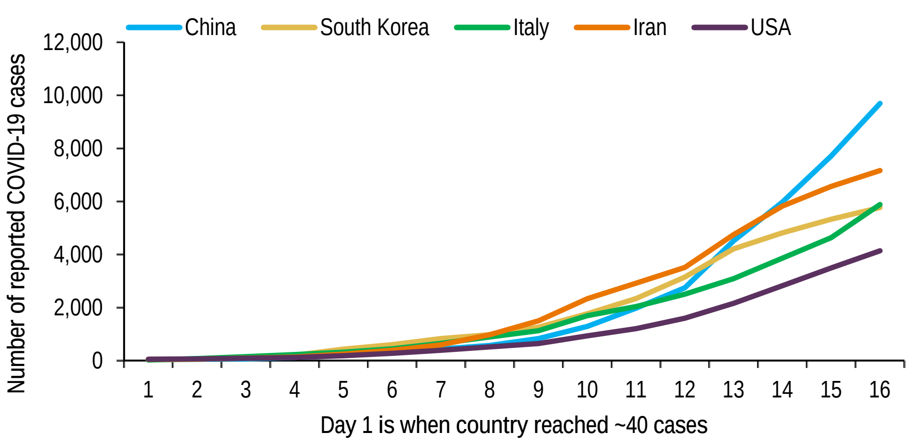
Source: Bloomberg., Johns Hopkins, BofA Global Research

Figure 7: Daily percentage increases in number of reported COVID-19 cases



Source: Bloomberg., Johns Hopkins, BofA Global Research

Figure 8: First 16 days of COVID-19



Source: Bloomberg., Johns Hopkins, BofA Global Research

Drawing credit lines

Nine more companies – AerCap Holdings, Micron, Carnival Corp, Anheuser-Busch InBev, Kraft Heinz, Air Canada, Caesars Entertainment, MGM Resorts, and Park Hotels – have announced intentions to draw down credit lines.

Figure 9: Drawing down credit lines in response to Coronavirus

Date	Company	Color
3/11/20	Boeing	Boeing is planning to draw down the full amount of a $13.8 billion loan as early as Friday due to 737 Max grounding cash needs, and also the new pressures mounting at airlines due to the Coronavirus.
3/11/20	Hilton	Hilton Worldwide Holdings Inc. is planning to draw down a portion of a $1.75 billion loan as it grapples with the impact of coronavirus on global travel.
3/11/20	Wynn	Wynn Resorts is planning to draw down a portion of its $850 million revolving credit line as the casino operator grapples with the coronavirus pandemic's impact on its revenues.
3/11/20	Royal Caribbean Cruises	Royal Caribbean Cruises said it exercised accordion features of two credit facilities to obtain access to an additional $600mn.
3/11/20	Blackstone	Blackstone asks its companies hurt by virus to tap credit lines.

Figure 9: Drawing down credit lines in response to Coronavirus

Date	Company	Color
3/11/20	Carlyle	Carlyle asks its companies hurt by virus to tap credit lines.
3/13/20	AerCap Holdings	AerCap Holdings and certain of its subsidiaries are party to a $4.0 billion unsecured revolving credit facility with a syndicate of financial institutions that matures in February 2024.
3/13/20	Micron	Micron Technology, Inc. says it increased its borrowings as a precautionary measure in order to increase its cash position and preserve financial flexibility in light of current uncertainty in the global markets resulting from the COVID-19 outbreak. As of March 13 a total of $2.5 billion was outstanding under the Revolving Credit Facility.
3/16/20	Carnival	Carnival is taking additional actions to improve its liquidity, including capital expenditure and expense reductions, and pursuing additional financing. Provided notice to the lenders to borrow approximately $3b under its facility agreement for a period of six months.
3/16/20	Anheuser-Busch InBev	Anheuser-Busch InBev has drawn down its entire $9 billion loan facility. "At any given time, we work to have enough cash on hand to meet our liquidity needs for more than one year, especially in times of increased volatility," the company stated.
3/16/20	Kraft Heinz	Kraft Heinz Co is planning to draw down as much as$4 billion from its revolving credit facility
3/16/20	Air Canada	Air Canada has withdrawn its financial forecasts for the next two years, drawn down its $600 million revolving credit facility and cut schedules as more people stay grounded
3/16/20	Caesars Entertainment	Caesars Entertainment Corp says it had fully drawn the remaining available capacity under each of the Revolving Credit Facilities as a precautionary measure in order to increase its cash position and preserve financial flexibility in light of current uncertainty in the global markets. Borrowings were approximately in the amount of $975.5 million under the CRC Revolving Credit Facility, $161.4 million under the CEOC LLC Revolving Credit Facility and $15 million under the CBAC Revolving Credit Facility
3/16/20	MGM Resorts	MGM Resorts International plans to draw down as much as $1.5 billion in backup loans
3/16/20	Park Hotels	Park Hotels initiates $350mn draw from $1bn credit facility

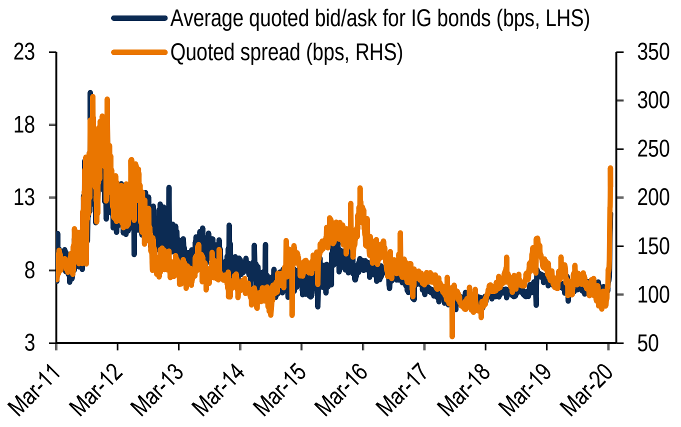
Source: Bloomberg

Worsening realized bid/ask in front end

Quoted IG bid/ask spreads continued to widen through last week, while the realized average trading costs estimated based on TRACE declined Friday and today. Across the curve bid/ask spreads increased the most for short-term and the least for back-end bonds since the start of the current selloff. While the disruptions in the short-term markets likely contributed (see CP / CD still frozen; Fed needs to do more), trading costs in the front-end also increased more during past episodes of market stress (Figure 16).

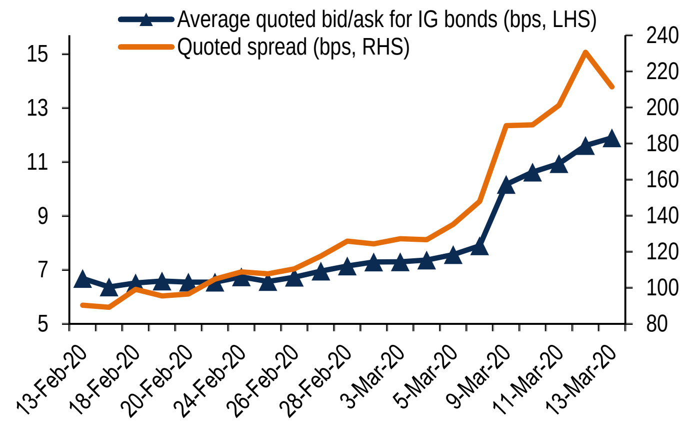
We measure IG bond bid/ask in two ways: 1) based on quotes and 2) the difference in dealer buy and sell levels on TRACE, which is an indicative of the "realized" bid/ask in the market. The average quoted bid/ask rose to 11.9bps on Friday from 11.6bps on Thursday (Figure 10, Figure 11). On the other hand IG bid/ask estimated based on TRACE declined to 7.8bps based on today's preliminary data, down from 8.5bps average on Friday and 9.9bps average on Thursday (Figure 12, Figure 13). Focusing on the curve our preliminary data suggests bid/ask increased sharply for 1-3yr bonds today, rising to 18.3bps from 12.8bps on Friday, while bid/ask declined for longer maturities. Quoted bid/ask continued to increase last week for 1-3yr and 3-5yr bonds but started to stabilize for 5-10 and 10+yr bonds (Figure 14, Figure 15).

Figure 10: Quoted bid / ask vs. spreads: historical



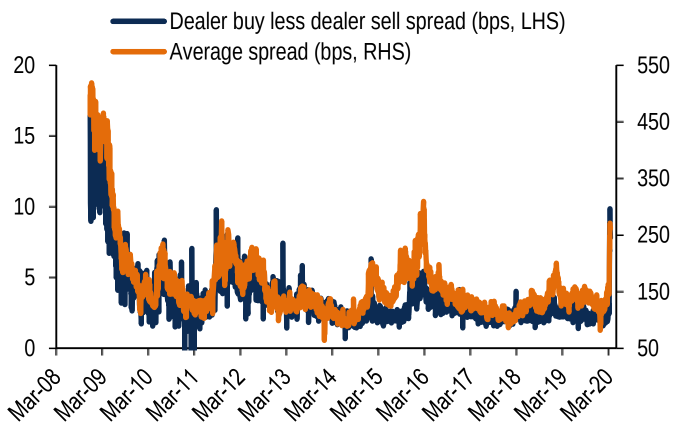
Note: for IG index bonds only.
Source: BofA Global Research

Figure 11: Quoted bid / ask vs. spreads: recent



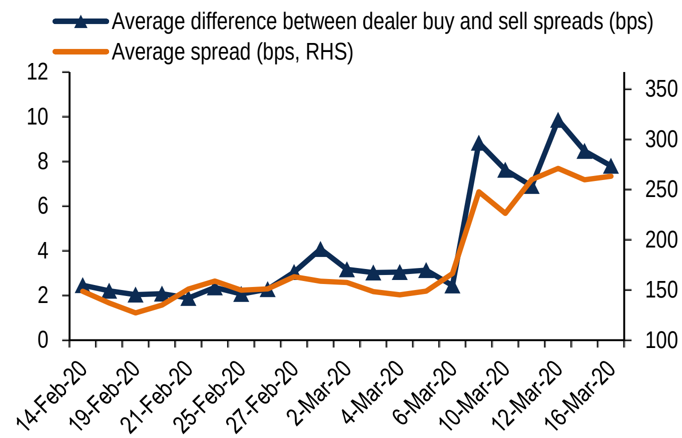
Note: for IG index bonds only.
Source: BofA Global Research

Figure 12: Average bid/ask based on TRACE: historical



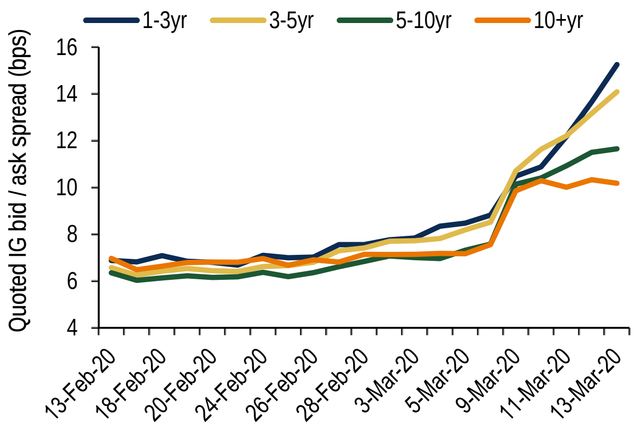
Note: based on dealer-to-client buy and sell trades of at least $1mn for IG index bonds.. Plotting daily average difference between dealer buy and dealer sell trade spreads for the same bond on the same day.
Source: BofA Global Research, TRACE.

Figure 13: Average bid/ask based on TRACE: recent



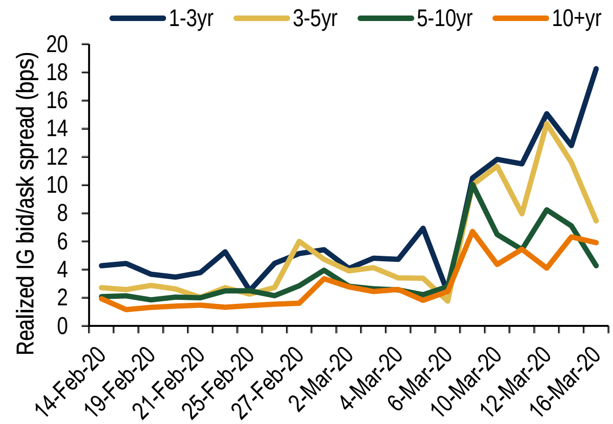
Note: based on dealer-to-client buy and sell trades of at least $1mn for IG index bonds.. Plotting daily average difference between dealer buy and dealer sell trade spreads for the same bond on the same day.
Source: BofA Global Research, TRACE.

Figure 14: Quoted bid/ask spreads widened the most for front-end bonds



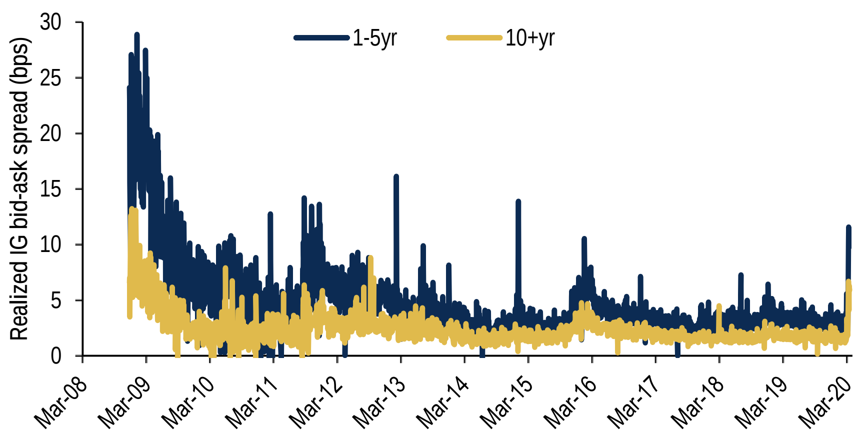
Note: for IG index bonds only.
Source: BofA Global Research

Figure 15: Realized bid/ask widened sharply today for 1-3bonds



Note: based on dealer-to-client buy and sell trades of at least $1mn for IG index bonds. Plotting daily average difference between dealer buy and dealer sell trade spreads for the same bond on the same day.
Source: BofA Global Research, TRACE.

Figure 16: Realized bid/ask widened more in terms of stress for front-end bonds



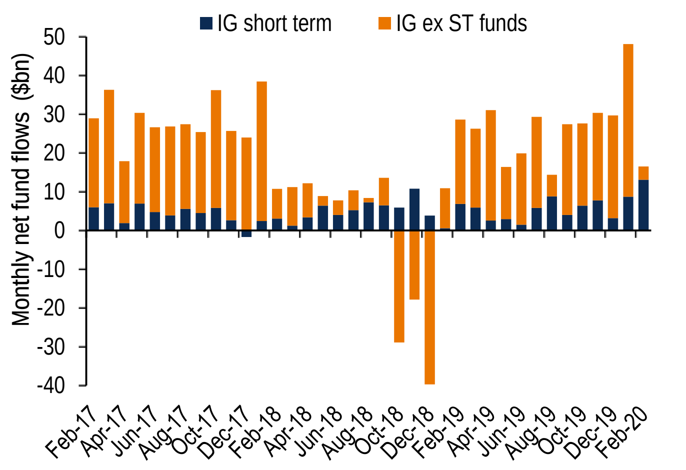
Note: based on dealer-to-client buy and sell trades of at least $1mn for IG index bonds. Plotting daily average difference between dealer buy and dealer sell trade spreads for the same bond on the same day.
Source: BofA Global Research, TRACE.

Final fund flows update for February 2020

Our vendor released the final US IG bond fund and ETF flow data for February 2020 today, showing $16.5bn of net monthly inflows, down from the record month of $48.1bn in January 2020 and even below the $24.3bn sum of daily inflows in February due to a large discrepancy in the intermediate category. Looking at the details of the February report, inflows increased to $13.1bn from $8.7bn in January for short-term IG, but dropped to $3.4bn from $39.4bn in January for IG ex. short-term (Figure 17). Finally alongside the recent global market selloffs, the pace of flows for daily reporting US IG bond funds and ETFs has turned negative to the tune of $10.8bn on Friday, averaging $1.96n/day month-to-date in March 2020 so far (Figure 18).

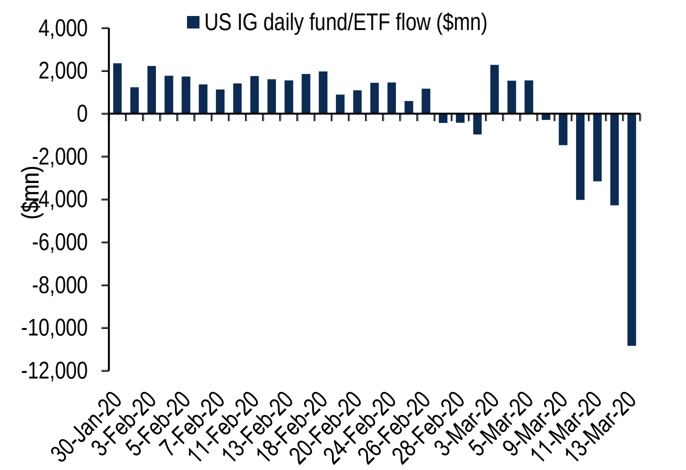
Note that flows data for the full universe of bond funds and ETFs is released monthly with about a two week lag. A subset of funds and ETFs – accounting for about half of the total AUM – report flows more frequently, such as daily or weekly. Hence the final monthly flows differ substantially from their daily and weekly counterparts.

Figure 17: Monthly US IG bond fund & ETF flows



Note: We exclude two volatile funds from our aggregate data.
Source: EPFR Global, BofA Global Research.

Figure 18: Daily US IG bond fund & ETF flows



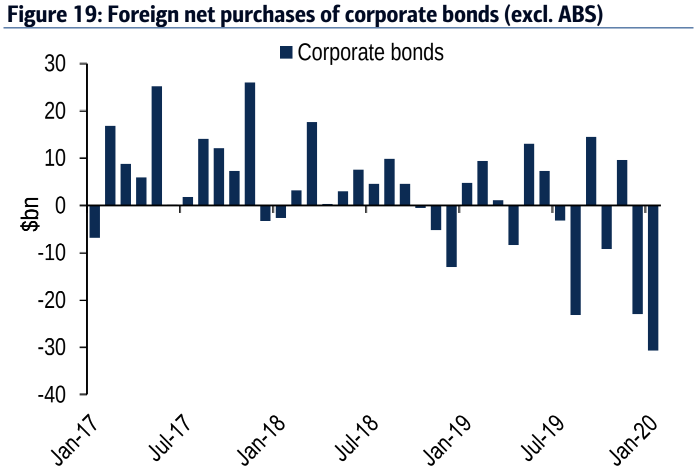
Note: We exclude two volatile funds from our aggregate data.
Source: EPFR Global, BofA Global Research.

TIC update for January

According to TIC (Treasury International Capital) data released today, foreign investors net sold $30.7bn of US corporate bonds (excluding ABS) in January, after on net selling $23.0bn in December (Figure 19). Note that the TIC data tends to significantly underestimate the actual amount of foreign buying (see: [Credit Market Strategist: One year round-trip in spreads 15 July 2016]). In January foreign investors also net sold $4.3bn of non-Agency Bonds, while net buying $25.6bn of Treasuries, $6.8bn of Agency MBS, $3.9bn of Agency Bonds, and $2.0bn of Stocks (Figure 20).

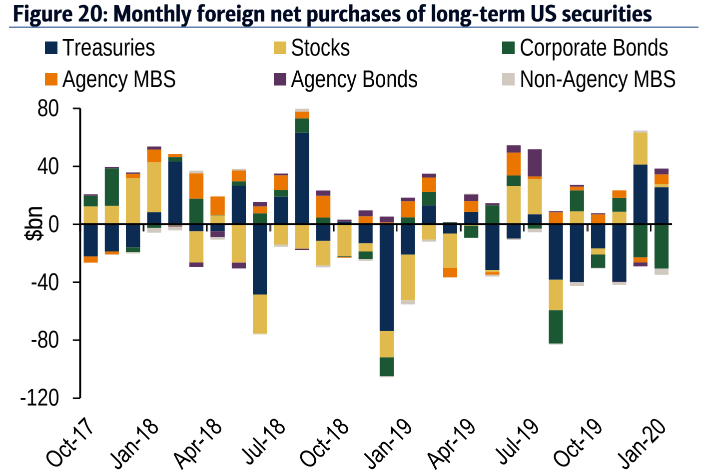
By region, where data includes ABS, European, Caribbean and Canadian investors net sold $26.2bn, $4.0bn and $2.7bn of US corporate bonds in January, respectively, while Asian investors net bought $0.5bn (Figure 21). Within Asia, Japan and China net bought $0.60bn and $0.10bn, respectively, while the rest of Asia net sold $0.22bn (Figure 22). Notice that this data on the geographical breakdown of foreign purchases is fairly useless as it tracks the money manager – i.e. often not the root source of demand.

Figure 19: Foreign net purchases of corporate bonds (excl. ABS)



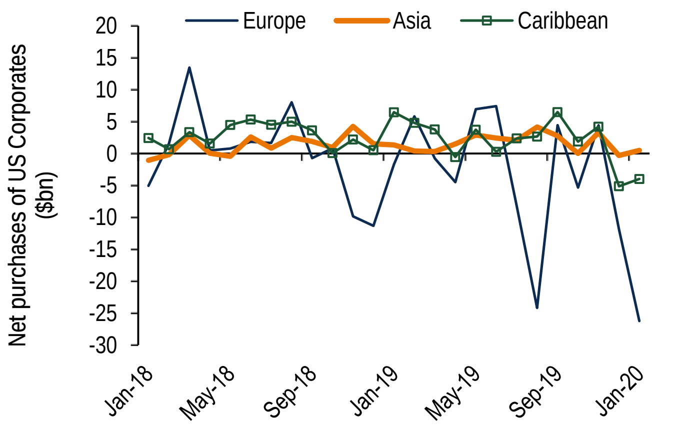
Source: TIC system, BofA Global Research

Figure 20: Monthly foreign net purchases of long-term US securities



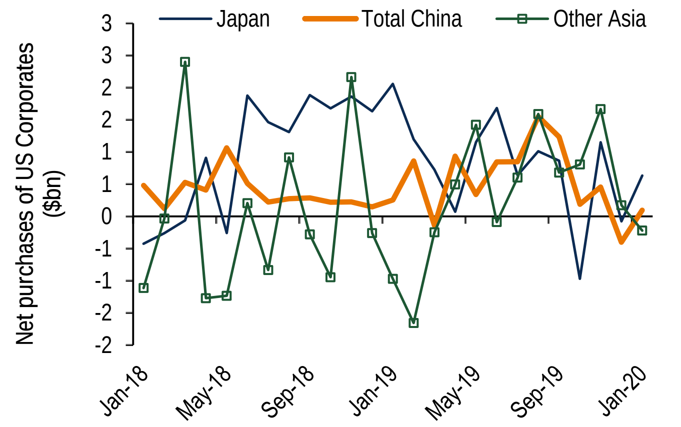
Source: TIC system, BofA Global Research

Figure 21: Geographic breakdown of foreign net purchases of Corporate bonds (incl. ABS) ...



Source: TIC system, BofA Global Research

Figure 22: ... breakdown within Asia (incl. ABS)



Source: TIC system, BofA Global Research

Daily credit snapshot

No US IG new issuance today. Despite the Fed announcing on Sunday another emergency rate cut of 100bps to zero lower bound and a QE program at least $700bn in size ($500bn Treasuries, $200bn MBS), as well as providing liquidity via other channels, equities (S&P 500) closed down 12.0% today, the Treasury curve bull-flattened with 2-year, 5-year, 10-year and 30-year yields down 13.0bps, 22.6bps, 24.2bps and 24.5bps, respectively, CDX IG widened 19.00bps, while CDX HY dropped $4.60pts. Liquid cash bond spreads underperformed CDX with US banks quoted 40-50bps wider, TMT and consumer retail 15-50bps wider, healthcare and energy 15-35bps wider, utilities 10-40bps wider, and industrials 10-25bps wider on the day. Bloomberg TFLO data estimates that dealer inventories increased by $700mn today as of the time of this writing.

Previously published here

[Credit Market Strategist: The long and short of confidence shocks 13 March 2020]

Credit Market Strategist: The long and short of confidence shocks

- The long and short of confidence shocks. We are dealing with a short term confidence shock, not a long term one like the financial crisis. The root driver - i.e. COVID-19 is - highly predictable, unlike the housing bubble and subprime. We are seeing/expecting global central banks becoming aggressively more accommodative. More importantly fiscal policy responses are starting to roll out globally. In the US it appears that equities down 27% was the "TARP moment", as news reports suggest a US fiscal package. IG spreads meanwhile at 222bps as priced in a 85% probability of a normal recession, which is much more severe than the short term dip we are looking at here. Valuations compelling. Strategically (long term) overweight IG.

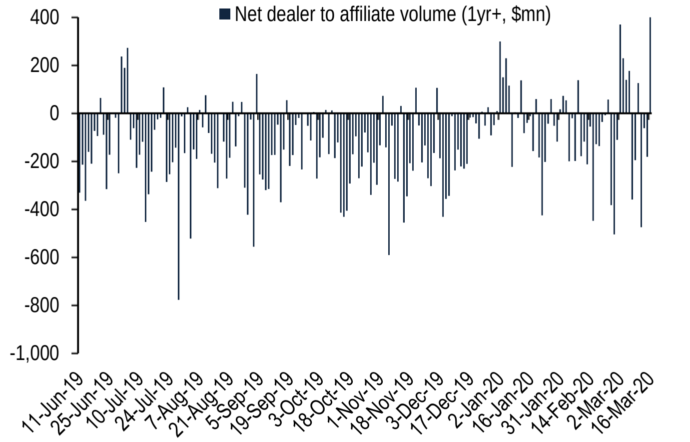
- BBBs vs As. This is when commentators begin warning about Fallen Angel risk but BBBs have outperformed this year on risk adjusted basis.

- Fallen Angel risk. The majority of BBB names trading at BB levels are in the energy sector. We review Analyst color on Fallen Angel risk in various sectors.
- Coronavirus tracker. Italy recorded a 17% increase in new COVID-19 cases today, down from 21% yesterday and below the mid-20s % type numbers until a few days ago (Figure 4). That suggests we are seeing signs that Italy is able to better control its COVID-19 outbreak. US infection numbers will continue to get much worse in coming days but should improve towards the last part of next week.
- Coronavirus impact on corporate earnings. Expected earnings growth in 2020 to 5.4% (6.0% ex. Energy), down from 6.5% on March 6 and 8.1% in December '19.
- Drawing credit lines. Six companies made announcements.
- Forensic flow analysis for 4Q19. Mutual funds and ETFs net bought $115.8bn.
- Wider bid/ask spreads. The average difference between dealer buy and sell spreads on TRACE jumped to 9.9bps on Thursday from 2.4bps on Friday.
- Liquidating ETFs, buying bonds. Outflows and liquidations of bonds are being met with buying at wider levels by traditional credit investors.
- More bang for the buck. USD IG cheaper than EUR counterparts currency hedged for the first time since 2016. Steeper Treasury curve means 20-year sweet spot.
- Where we stand on spreads. 73bps wider this week and 123bps wider since the January 17 tights. Significant widening in front end and curve inversion.
- Flow: Record outflows from HG. $7.34bn US IG fund/ETF outflow.
- Supply: Still market dependent. $5.7bn this week, $10-60bn next week.

Daily foreign demand tracker

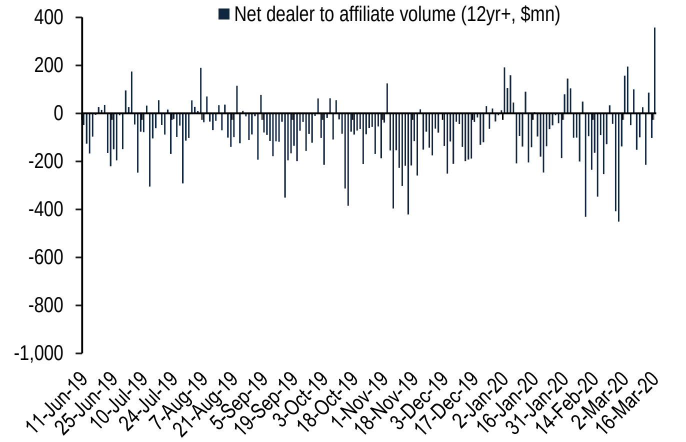
We believe net dealer-to-affiliate volumes from Trace are correlated with foreign buying of US HG corporate bonds - i.e., negative numbers mean foreign investor buying (US dealers taking down inventory in favor of foreign affiliates). For supporting material see our "primer" on tracking foreign inflows (See: Credit Market Strategist: One year round-trip in spreads 15 July 2016). Figure 23 shows the overall daily dealer-to-affiliate volumes while Figure 24, Figure 25 and Figure 26 show subsets of this data. In particular Figure 24 shows net dealer-to-affiliate volumes for longer maturity (12+ years) bonds, Figure 25 displays volumes reported to Trace before 8am NY time (biased toward Asian buying) and Figure 26shows the subset of net trades reported between 8am and noon (biased toward European buying). Figure 23 and Figure 24 include data from today, whereas Figure 25 and Figure 26 run through the previous business day.

Figure 23: Net dealer buying from affiliate (1yr+)



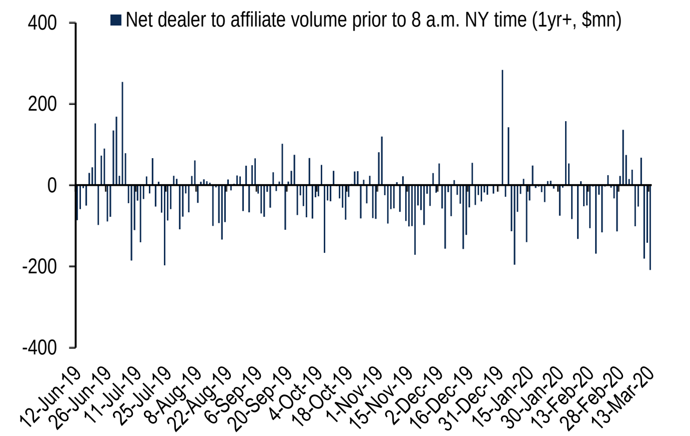
Note: Net dealer-to-affiliate volumes are correlated with foreign buying/selling. Negative numbers indicate foreign buying.
Source: Bloomberg, TRACE

Figure 24: Net dealer buying from affiliate (12yr+)



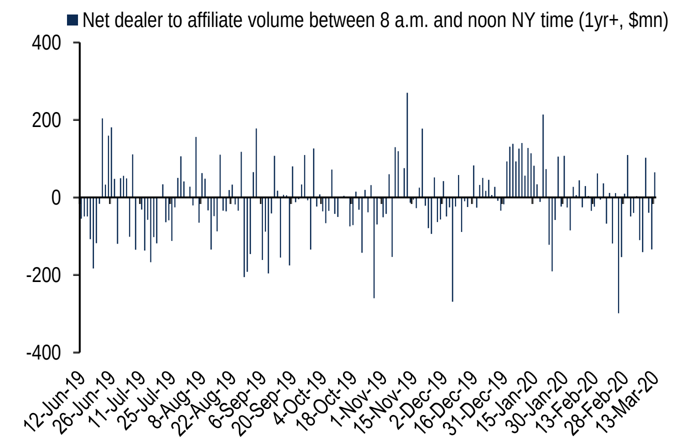
Note: Net dealer-to-affiliate volumes are correlated with foreign buying/selling. Negative numbers indicate foreign buying.
Source: Bloomberg, TRACE

Figure 25: Net dealer-to-affiliate trading volumes before 8 a.m. NY time



Note: Morning share of daily trading volume is correlated with secondary market activity of foreign investors due to different time zones.
Source: BofA Global Research, TRACE

Figure 26: Net dealer-to-affiliate trading volumes 8 a.m. - noon NY time



Note: Morning share of daily trading volume is correlated with secondary market activity of foreign investors due to different time zones.
Source: BofA Global Research, TRACE

Economics, Rates & FX Strategy

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Previously published here
US Rates Watch: CP / CD still frozen; Fed needs to do more 16 March 2020

CP / CD still frozen

CP / CD relief needed through 13-3 or other regs

On Sunday the Fed cut rates to zero and officially started QE to aid UST market functioning. However they did not announce any facilities specifically directed at the CP/CD market. Without such a program we expect that the CP/CD market will remain frozen in the near term and we will continue to see stress in credit linked front end markets. LIBOR and CP continue to rise versus OIS (Chart 1) and cross currency markets have showed significant signs of stress as investors demand USD (Chart 2). The Fed needs to pursue some or all of: (1) Commercial Paper Funding Facility (CPFF) (2) buy CP / CD directly from dealer balance sheets (3) Money Market Investor Funding Facility (MMIFF). The Fed needs to signal that these programs are coming as soon as possible to reduce credit concerns and calm funding markets. A statement today would help.

Source of CP stress: The CP market is frozen as dealer balance sheets are constrained but corporates need to issue and MMFs want to sell. Corporates rely on the CP market as a reliable source of short-term cash. To the extent corporates are not able to access CP markets they will turn to bank lines of credit, which could raise funding needs for banks and increase market stress. We have already seen total CP issuance start to decline and concentrate in very short tenors (Table 1).

At the same time, MMFs seek to reduce CP holdings to raise cash and build liquidity buffers ahead of an expected increase in investor outflows. We have already started to see outflows from prime institutional funds (Chart 3) and this may spill over into government MMF depending on the severity of quarantines & concerns over access to cash. Prime funds also continue to increase their liquid assets in preparation of outflows.

Prime MMF also key source of dealer non-traditional funding: The prime MMF scramble for cash is leading to a reduction in "evergreen" financing arrangements for dealer non-traditional collateral. "Evergreen" arrangements are where prime MMF agree to keep funding dealer non-traditional collateral for a 35 or 95D period. However, MMF have a right to terminate the "evergreen" on any day and then the repo arrangement just rolls down to eventually maturity (i.e. if terminated the 35D funding becomes 34D tomorrow, etc).

Right now MMF are terminating their "evergreen" financing arrangements to bolster cash. This means that after the 35 or 95D period there will be no funding for this non-traditional collateral. The dealer will then likely have to hold the non-traditional assets on their own books / balance sheet. Dealers will not want to hold these assets and will sell them into the market. This will likely exacerbate the current illiquidity and spread widening in the market.

Note: non-traditional collateral = private label MBS, HY corporates, etc

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Japan Macro Watch: BoJ review: everything but cuts 16 March 2020

BoJ review: everything but cuts

The BoJ today brought forward its regularly-scheduled policy meeting for 19 March and announced a package of easing measures to support the economy and markets in light of the deepening COVID-19 shock. The details of the package were largely in line with our and consensus expectations for the 19 March MPM and consisted of: 1) Measures to facilitate corporate financing, including a new funds-supplying program, and top up in purchases of commercial paper and corporate bonds; 2) "Doubling" of ETF and J-REIT purchase targets to JPY12trn and JPY180bn, respectively; and 3) Commitment to provide ample yen liquidity and ensure stable US-dollar funding conditions through various operations.

The announcement follows earlier emergency actions by the Fed, RBNZ, BoC, and underscores the urgency of global central banks as they try to mitigate the fallout of the COVID-19 outbreak. Though the liquidity and financing support programs are helpful and will provide an important backstop for funding markets, we think the overall package was underwhelming and underscores the BoJ's limited options as it tries to support growth. Given the severity of the COVID-19 shock, we think the greater onus will be on fiscal policy to support the economy and that investors' focus will now turn to additional stimulus measures from the government.

A temporary acceleration in ETF purchases

Table 2 summarizes the measures announced today. The main "surprise" relative to consensus expectations was the formal lifting of the ETF purchase target to an "upper limit" of JPY12trn annualized. The BoJ had already been ramping up its equity purchases this month in response to the deepening rout in markets, increasing its per-round buying to JPY101.4bn, from the ~JPY70bn pace that was the norm in recent years. As part of the July 2018 policy tweaks, the BoJ had changed the language around its ETF and J-REIT purchases, stating that it would conduct its buying flexibly and that the "Bank may increase or decrease the amount of purchases depending on market conditions." But the change in the target gives a more explicit signal that the central bank would be accelerating its buying further in the near-term, to around "double" the prevailing pace. Note, however, that the BoJ has made it clear that the ramp up in ETF purchases would be a temporary measure, in place while COVID-19 related market volatilities and economic uncertainties remained high. (see full report for footnote) The language gives the BoJ cover to resume its tapering of ETF purchases, if market conditions allow.

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US Watch: Fed: another 100 and QE 15 March 2020

Fed: another 100 and QE

Emergency 100bp and more

The Fed delivered another inter-meeting cut of 100bps, bringing the fed funds target range to 0-0.25%. The Fed set IOER at 0.10% and ON RRP at 0.0% (Chart 1). This comes after the Fed cut 50bps on March 3rd which aimed to calm markets amid the COVID-19 outbreak. In the policy statement, the Fed acknowledged that "The coronavirus outbreak has harmed communities and disrupted economic activity in many countries, including the United States" and provided forward guidance that the Committee expects to keep rates at zero "until it is confident that the economy has weather recent events..." Moreover, Chair Powell during his teleconference said the Fed is willing to do more without giving specifics and reinforced the forward guidance of "low for long". Taken together, this means that the Fed expects to stay at zero even once the economy has started to improve. In other words, the Fed is not just cutting in the face of this shock with a quick reversal thereafter.

In addition to the rate cut, the Fed restarted its QE program, pledging to buy at least \$500bn in Treasury securities and \$200bn in agency MBS over the coming months. It also noted that it will reinvest all principal payments from the Fed's holding of agency MBS holdings back into agency MBS. The Fed's repo operations remain unchanged, with overnight operations set at 0.1% on Monday and 1month term at 0.25%. Chair Powell highlighted in his teleconference that purchases will be open-ended and the NY Fed desk will buy across the curve as needed to restore market functioning. He emphasized this is the most important goal that the Fed has right now. The Fed will continue to use tools to achieve such. However, Chair Powell ruled out asking for new authority to buy other financial instruments. More on pace and schedule in this note.

Other key decisions were taken to support credit conditions. It lowered the primary rate at its discount window by 150bps to 0.25% and increased the duration up to 90 days. The Fed also reduced the reserve requirements to zero for depository institutions. Lastly, it announced USD liquidity swap line arrangements. However, the Fed did not address any program to address pressures in the CP & CD markets; we expect unsecured funding pressure to build until such a program is announced.

The Fed's actions should help to stem some of the panic in markets, but it is just the start. We think the proper policy response will require coordinated and forceful action from both the fiscal and monetary front. The news on Friday from the White House is encouraging - regarding a targeted stimulus - but we will also need to see action from the Treasury to provide a financial backstop. However, we don't think this will stop the weakening in the economy. Businesses are shutting doors globally and households are moving into quarantine. We are already forecasting negative GDP growth in 2Q but the risk is that it proves to be a much deeper and more prolonged contraction in economic activity.

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China Economic Watch: Sharp contraction in Jan-Feb activity data on Covid-19 disruptions 16 March 2020

Sharp contraction in Jan-Feb China activity data

Jan-Feb activity growth slumped amid Covid-19 outbreak

Activity growth data in Jan-Feb 2020 fell sharply, as economic activities were held back by efforts to contain the virus spread since late Jan. While it is difficult to forecast the impact of such an unprecedented event with precision, it is even more challenging to second guess the level of reported drop that is acceptable to policy makers. The fact that reported contraction in industrial activities and consumption is much greater than consensus suggests a higher level of tolerance for weak data, at least in 1Q20.

- IP (industrial production) fell by 13.5% yoy in Jan-Feb, vs. +6.9% in Dec 2019. Manufacturing IP fell sharply (by 15.7% yoy), especially for auto making (-31.8%), general machinery (-28.2%) and other transportation equipment (-28.2%). Utility IP fell comparably less, by 7.1% yoy, vs. +6.8% in Dec 2019.

- FAI (fixed asset investment) dropped by 24.5% yoy in Jan-Feb, vs. +5.4% in 2019 (and an estimated +11.8% in Dec 2019 alone). It was notably worse than market expectation of -2.0%. FAI of mfg., infra. and property contracted by 31.5%, 26.9% and 16.3% yoy respectively from a growth of 9.2%, 2.1% and 7.4% in Dec 2019.

- Retail sales declined by 20.5% yoy in Jan-Feb after rising 8.0% in Dec 2019. It was led by a slump in catering revenue (-43.1% yoy) with goods sales down by 17.6%. Sales of discretionary and durable goods dropped particularly significantly, such as jewelry (-41% yoy), auto (-37%), furniture (-34%) and home appliance (-30%). On the other hand, that of food and beverage grew by 9.7% and 3.1%. Online sales of goods grew 3.0% yoy, despite slowing from 19.5%.

- Service sector gross output index fell by 13.0% yoy in Jan-Feb vs. +6.8% in Dec. Surveyed urban unemployment rate rose to 6.2% in Feb from 5.2% in Dec.

The risk of a negative yoy 1Q GDP print on the rise

We see further downside risks to our already cautious GDP growth forecasts. In addition to weaker external demand caused by widespread disruptions of the outbreak, a more determined gesture by Chinese policy makers to eliminate the gap between underlying data and reported data (at least for 1Q20) implies that YoY quarterly GDP growth can potentially go into negative territory. On the Mar 10th State Council working meeting, Premier Li also commented "it is not a big deal to see economic growth being a bit higher or lower, as long as employment stabilizes this year.

Now with unemployment rate jumping to a multi-year high, policy focus will likely shift towards job protection/creation, esp. at SMEs. While this implies a potential miss of the long-term growth target, we believe China will prioritize social stability concerns and step up on fiscal support.

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