HOW THE FED FAILED TO ALLEVIATE MARKET FEARS

The Fed cuts interest rates to almost zero. Markets seem to interpret this as an act of monetary helplessness. It looks like some policy responses are as scary as the virus itself.

IN A NUTSHELL

_ The Fed's large rescue package misses its mark.
_ At this stage, government rescue packages are necessary but insufficient to calm markets.
_ In the short term, only the coronavirus development itself might bring relief. Here, the focus should be less on the number of new daily infections than on the progress and preparedness in dealing with the pandemic.

To illustrate how extraordinary these times are from a market perspective, it is enough to look at the actions of the U.S. Federal Reserve (Fed) on Sunday evening and the subsequent market reaction. After its second extraordinary meeting this month, the Fed announced that it would cut its key interest rate by one full percentage point to the band from 0.00% to 0.25%. At the same time, it announced bond purchases to the amount of 700 billion dollars and numerous measures to support short-term liquidity in money markets. Together with other central banks, it also aimed at meeting the international demand for U.S. dollar liquidity. The market reaction was sobering. Main U.S. and European equity indices lost more than 10% in very volatile markets on Monday. Again, the price of a barrel of oil (West Texas Intermediate (WTI)) fell well below 30 dollars. Gold once again served not as a safe haven but as a source of liquidity and lost in value. Most revealing was the market reaction when it came to interest rates. U.S. Treasury yields, whether on the shorter or on the longer end of the curve, reacted much less to the massive rate cut than one would have expected in more normal market times. Bund yields hardly reacted at all. The market was also unimpressed by further aid packages from other central banks (the Bank of Japan announced the doubling of equity-market ETF purchases to 12 trillion yen per year and China pumped 13.2 billion dollars into the system).

One reason for this could be that the Fed's latest and drastic cuts showed the remaining equity investors the seriousness of the situation. Another is that it ended market hopes of further rate cuts later on, not least by making it clear that it would not go below the zero threshold. The Fed should probably not be counted on as a support for the stock markets for the time being. Instead, monetary and fiscal rescue packages are seen merely as a necessary means of ensuring that the markets and the economy function as well as it is possible under these difficult circumstances. Pain relief, but not disease control.

These market reactions imply that investors are currently as anxious as the general population: the aid packages of central banks and governments cannot compensate for the negative news on the corona pandemic, while medical providers are struggling to contain it. So what might relieve the situation? There are two ways to think about this: from a medical point of view and from a social one. By the latter we mean a more practiced approach to the pandemic, an arrangement with the current situation. After all, once imposed, any precautionary measures should not be taken back quickly. This would be politically sensitive as long as no real progress can be seen on the medical side. So people and companies will have to adjust to the still very new situation in the course of the next few weeks, while the financial stress is expected to stay high for many companies.

The relief from a medical point of view could again take several routes. First of all, we would propose to move away from focusing too much on the daily number of new infections in different countries. It may be premature to hope that once a trend reversal and containment is in place it will be irreversible in China, Japan, Singapore, Taiwan, South Korea and a growing list of other countries in coming weeks and months. Especially as the circumstances in the respective countries differ greatly. Investors would be well advised to prepare themselves for the fact that the peak in absolute new infections in Europe, and also in the United States, may drag on for several weeks or even months. After all, it is the declared aim of the safety measures to slow down the speed of new infections in order not to overwhelm the health-care systems in various countries. Another channel would be a vaccine, of course. In this respect, we would not rule out surprises, including positive ones, but as a core scenario we should probably not expect this before the end of the year at the very earliest. Finally, and this is probably the most underestimated glimmer of hope at the moment, there is a good chance of improved medical-treatment options for coronavirus patients within a matter of months. The different mortality rates in the various countries already show how much of a difference preparedness and growing familiarity with the virus, not to mention well rested medical practitioners, can probably make. The virus would lose much of its horror if further progress were made.

For the time being, however, investors are likely to react to other signals, even if they are contradictory. On the positive side, there is the declining number of new infections in China, currently only in the double digits – in absolute terms. The same is true of Japan, Singapore and South Korea, where the new infection curve has flattened considerably. As already mentioned, we caution against placing too much emphasis on parallels here. Many market participants also take a positive view of the statements of the Director General of the World Health Organization (WHO), according to which the virus is perfectly controllable and therefore herd immunity does not have to be present in order to achieve a reduction in new infections.

Directly opposing are the statements of Chancellor Merkel as well as the senior health advisor of the British government, who assume that the majority of the population, about two thirds, must have been exposed to the virus before it can be contained. The absolute number of new infections in Italy must also be seen as a negative, even though the daily growth rate of infections fell from 35% to just under 20% within two weeks. If the government's tougher measures do not quickly lead to a further sharp drop in the rate of new infections, the number of infections could reach a hundred thousand in a few weeks.

Irrespective of a possible positive turnaround, it already seems foreseeable that the far-reaching standstill of the majority of public life, the border closures and the liquidity shortfalls in Europe and probably also in the United States could lead to a significant decline in economic output. Most probably, no central bank or government (via development banks) can prevent this in the short term, no matter how quickly they act. We cannot yet foresee the extent of this decline in economic activity, as it will depend on the length and scope of further security measures. How unreliable forecasts can prove is visible in the latest Chinese data: industrial production fell by a combined 13.5% (analysts' consensus was a 3% decline) in January and February, retail sales by 20.5% (consensus was a 4% decline) and capital expenditures by 24.5 % (consensus was a 2% decline).

Back to the markets. We believe that the speed and magnitude of the market correction combined with the continued high volatility means that many portfolio shifts are still due, likely leading to choppy markets staying with us for the coming days. With a lot of risk budgets exhausted due to the higher risks, many investors would probably have to continue to dispose of equities and corporate bonds. Even the central banks' rescue packages can do little to change this. At least these take some pressure off highly leveraged market participants to immediately sell off investments on a larger scale.

The Stoxx Europe 600 has now fallen 37% from its peak on January 20. The index is thus at its end-of-2012 level. Germany's Dax has fallen back to where it was trading in mid-2013. The S&P 500, on the other hand, was still trading at the level it first reached in summer 2017 despite the massive slump on Monday. In Europe, the index levels are now close to the levels corresponding to the aggregated book values of the individual securities. This served as a floor at least in 2003 and 2009. In view of the very dynamic news situation, we would certainly not rule out the possibility of these levels being tested, and some indices temporarily falling below them.

APPENDIX: PERFORMANCE OVER THE PAST 5 YEARS (12-MONTH PERIODS)

	02/15 - 02/16	02/16 - 02/17	02/17 - 02/18	02/18 - 02/19	02/19 - 02/20
Dax	-16.7%	24.6%	5.1%	-7.4%	3.3%
S&P 500	-6.2%	25.0%	17.1%	4.7%	8.2%
Stoxx Europe 600	-12.0%	14.8%	5.9%	1.7%	4.5%

Past performance is not indicative of future returns.
Sources: Bloomberg Finance L.P., DWS Investment GmbH as of 3/16/20

GLOSSARY

Book value is the net value of a company's physical and intangible assets

Bunds is a commonly used term for bonds issued by the German federal government with a maturity of 10 years.

A central bank manages a state's currency, money supply and interest rates.

The Dax is a blue-chip stock-market index consisting of the 30 major German companies trading on the Frankfurt Stock Exchange.

An exchange-traded fund (ETF) is a security that tracks an index or asset like an index fund, but trades like a stock on an exchange.

Fiscal policy describes government spending policies that influence macroeconomic conditions. Through fiscal policy, the government attempts to improve unemployment rates, control inflation, stabilize business cycles and influence interest rates in an effort to control the economy.

The Japanese yen (JPY) is the official currency of Japan.

Leverage attempts to boost gains when investing through the use of borrowing to purchase assets.

Monetary policy focuses on controlling the supply of money with the ulterior motive of price stability, reducing unemployment, boosting growth, etc. (depending on the central bank's mandate).

The S&P 500 is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

A safe-haven investment is an investment that is expected to retain or even increase its value in times of market turbulence.

The Stoxx Europe 600 is an index representing the performance of 600 listed companies across 18 European countries.

Treasuries are fixed-interest U.S. government debt securities with different maturities: Treasury bills (1 year maximum), Treasury notes (2 to 10 years), Treasury bonds (20 to 30 years) and Treasury Inflation Protected Securities (TIPS) (5, 10 and 30 years).

The U.S. Federal Reserve, often referred to as "the Fed", is the central bank of the United States.

Volatility is the degree of variation of a trading-price series over time. It can be used as a measure of an asset's risk.

West Texas Intermediate (WTI) is a grade of crude oil used as a benchmark in oil pricing.

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