THIS MONTH'S TOPIC

Central banks are entering a new regime: unlimited support

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Coordinated actions by central banks and governments have a clear objective to prevent a sharp rise in bankruptcies. We are confident in central banks' ability to address the liquidity crisis as central banks have entered a new regime: unlimited support. However, we have no strong convictions on the depth of the coming solvability crisis.

Covid-19 is acting as an incredible accelerator to put an end to the cycle. A global recession is now inevitable in response to a combination of supply disruptions, dropping demand, and a sudden tightening in financing conditions. Coordinated and aggressive fiscal and monetary policy responses aim to ensure that the recession will be limited and does not morph into a deep economic depression. The big challenge for central banks and governments now is to avoid mass business bankruptcies, a very significant rise in unemployment and bank failures.

Otherwise, this economic cycle in developed countries was characterized by its exceptional duration, a sharp increase in corporate and sovereign debt, and ultra-accommodative monetary policies. Indeed, the credit cycle was stretched by record low rates and the implementation of asset purchase programs. We need to keep in mind that:

- Corporate debt reached record high levels, especially in the US and China over the past few years. American companies raised huge amount of cash on financial markets to buy back shares and have financed record amounts of merger and acquisitions.
- The growth picture was already weak before the public health emergency. 2019 GDP growth came in at its slowest pace since the 2008-2009 financial crisis. We expected 2020 global growth to stabilize at already low levels.
- Corporate default rates have been low over the past few quarters despite the weak global growth environment because of ultra-accommodative monetary policies and investors' complacency.

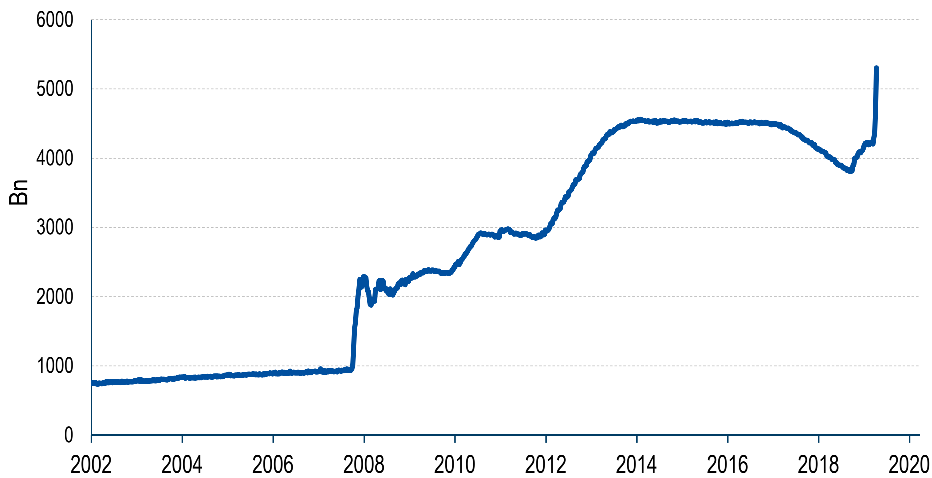
The non-financial corporate sector is the epicenter of this new crisis. Covid-19 and dropping oil prices will push up default rates on the back of falling profits and tightening financing conditions. The extent of bankruptcies will be a key factor in how long economies continue to weaken. This is a big difference with the 2008 financial crisis, which hit banks and financial institutions. What are the key measures being taken by major central banks?

Central banks are now entering a new regime: unlimited support. Central banks are putting in place unprecedented actions in order to:

- **In the short term: avoid a liquidity crunch.** In recent weeks, we saw a rise in risk aversion and massive outflows from bond funds. The flight to cash exacerbated asset price dislocation on the bond market. In response, major central banks are now buying corporate bonds and taking steps to support the commercial paper market. The commercial paper

The non-financial corporate sector is the epicenter of this new crisis

1/ **The Fed added $586bn in assets during the week ended March 25, bringing its total holdings to $5.3tr.**



Source: Bloomberg, Amundi Research - Data as of 25 March 2020

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market is vital for companies looking to fill short-term liquidity gaps, following the disruption caused by coronavirus.

- **In the medium term: monetize government debt**. Governments are deploying massive fiscal stimulus, including direct cash payments to households. In advanced economies, fiscal deficits will increase from 2-3% of GDP to around 10% or more. If this public assistance was financed through standard government debt, interest rates would rise sharply and kill the recovery. There is no choice but to fully monetize the upcoming increase in public debt.

The ECB announced a Pandemic Emergency Purchase Program (PEPP):

- This public and private securities purchase program covers €750bn and is in addition to the existing programs (€20bn monthly and envelope of €120bn till the end of the year). The ECB will buy assets at a pace never seen even in previous crises: it will buy more than €110bn per month by December; at most the ECB has bought €80bn per month.
- This new program is ultra-flexible: Greek securities are included, with no issuer limit, more latitude related to the capital allocation key, and the minimum residual maturity requirement lowered to 70 days.
- The ECB is now also buying commercial paper directly from big companies.

The Fed slashed rates to 0-0,25% and announced drastic measures to bolster market conditions:

- The Federal Reserve will buy an unlimited amount of Treasury and mortgage-backed securities. The FOMC will include purchases of agency commercial mortgage-backed securities in its agency mortgage-backed security purchases.
- Supporting the flow of credit to employers, consumers, and businesses by establishing new programs that, taken together, will provide up to $300 billion in new financing. The Department of the Treasury, using the Exchange Stabilization Fund (ESF), will provide $30 billion in equity to these facilities.
- Establishment of two facilities to support credit to investment grade companies – the Primary Market Corporate Credit Facility (PMCCF) for new bond and loan issuance and the Secondary Market Corporate Credit Facility (SMCCF) to provide liquidity for outstanding corporate bonds.
- Establishment of a third facility, the Term Asset-Backed Securities Loan Facility (TALF), to support the flow of credit to consumers and businesses. The TALF will enable the issuance of asset-backed securities (ABS) backed by student loans, auto loans, credit card loans, loans guaranteed by the Small Business Administration (SBA), and certain other assets.
- The Fed has also expanded central bank liquidity swap lines

It is difficult at this stage to assess the magnitude of the damage the virus will do to the economy. Coordinated actions by central banks and governments have a clear objective to prevent a sharp rise in bankruptcies. We are confident in central banks' ability to address the liquidity crisis as central banks have entered a new regime: unlimited support. However, we have no strong convictions on the depth of the coming solvability crisis. We expect: (1) central bank measures to anchor sovereign yields as additional sovereign debt supply will be absorbed by central banks' purchase programs; and (2) large companies to be favoured, as they will be key to supporting the recovery and limiting the rise in unemployment.

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