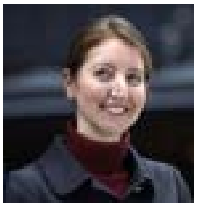

# Perspective

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# Top Questions From Our Clients In A Turbulent Time

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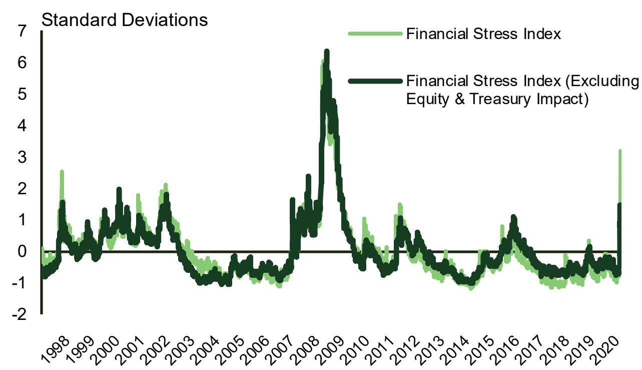
The measures taken across the globe to fight the COVID-19 pandemic are unprecedented in modern times. Policy announcements are changing by the hour. Nothing punctuates this more than the Federal Reserve's Sunday night bazooka announcement that dropped interest rates by 100 basis points, along with a slew of other measures enacted to assist with liquidity and credit flow. Naturally there is a lot of uncertainty about what the future holds. We address some of the more frequently asked questions from our clients to help navigate these uncharted waters.

## 1. *Are we headed for a recession?*

We know our clients are increasingly hearing the "R" word. The risks are certainly elevated given the unprecedented nature of this health and economic shock. Growth in the U.S. and Canada was hovering at 2% and 1%, respectively, in the pre-coronavirus world, which left little cushion.

The word, recession, has turned into a catch-all term that can reflect very different consequences. Typically, when there are two consecutive quarters of contraction, the "R-word" makes its appearance. But, the current situation is unlike anything we've seen before, with an abrupt stop in economic activity within large segments of the economy due to necessary widespread quarantine and travel restrictions. Policymakers are responding with proactive and targeted measures to support household and business incomes to mitigate the scope of job losses that are typical of a traditional economic recession.

**Chart 1: Financial Stress Elevated**




Source: WSJ, CBOE,ICE/BoA ML, FRB, TD Economics

We need a new economic vocabulary that goes beyond the "R word," to appropriately capture depth, duration and breadth. Absent economy-wide job losses, a two-quarter contraction typically fits the definition of a 'technical' recession. This appears to be what many forecasters are referring to when we took a deeper look at their forecasts. Most do not reflect large scale job losses across the country over a longer period of time. Likewise, there's a modest rise in the unemployment rate, anywhere between 20-50 basis points.

By comparison, our forecast has the unemployment rate in Canada rising to a tick above 6% and that in the U.S. to 4%, with a contraction in the second quarter for both countries. Fitting the size of the economic shock, we've estimated a fair degree of depth to that contraction. However, the setback lacks duration because our starting assumption is that the economy begins to normalize in the May through September period. Other forecasters have duration (i.e. two quarters), but not much depth. And very few forecasters seem to have both currently, although this could very well change with evolving events.

Many Canadians will remember that the first half of 2015 coincided with an outright contraction, meeting the two consecutive quarter definition of a technical recession. However, the job market was resilient across most industries and provinces, even as the national unemployment rate edged up over the course of the year. This was not 'scored' as an official recession for Canada, although it remains one under debate. However, that period didn't 'feel' good and when it came to the province of Alberta, there is no question of depth, breadth and duration during that period. They may again see a similar outcome in the months ahead. Like then, the energy sector remains under extreme stress due to the simultaneous flooding of supply from OPEC+ members and demand retreat from virus containment measures on travel.

Unfortunately for Canada, it did not enter this virus containment period on a strong economic back-foot, like the United States. The first quarter was already proving to be flat or slightly negative. So, it's not a wild assumption that a technical recession will land on Canada's history book irrespective of the outcome in the third quarter. This is not true for the United States.

### 2. *Should we fear the wild moves in the stock market?*

Shortly after the collapse in the stock market into bear territory in December 2018, we produced analysis to argue against fearing stock market volatility. Granted the recent rout that dialed the S&P 500 Index back to late 2018 levels in a short period is not common. The sharp move corresponds to a 7 standard deviation from historical norms.

However, our eyebrows have been raised at the broadening of financial stress across multiple bond, credit, liquidity and corporate indicators. This is a cause for concern of a possible larger negative credit-event. The TD Financial Stress Index (Chart 1) captures this aggregation and even when equity volatility is removed, the trend is not our friend. The index is standardized so that readings of zero equate to average levels of financial market stress, while those above zero represent higher levels. Currently the sub-index that removes the equity component roughly matches the 2012 and 2015 periods, when the European debt crisis and China's currency revaluation kicked up market angst. While this offers some comfort, the skyward, perfectly vertical slope of the index does not. Should this persist for several weeks, it would offer a leading indicator of higher odds of bleed-through to important measures of economic growth, such as consumer confidence and the ability of businesses to finance operations. This would amplify the economic shock that's already underway from containment measures of the virus.

### 3. *Why are central banks cutting aggressively when they have so few bullets?*

The question is best approached within a risk management framework. When a shock is perceived as relatively small, or short lived with a high degree of certainty on outcomes, this carries less urgency in requiring an immediate monetary response. But, large shocks, especially when coupled with high degree of uncertainty, are a marker for a prompt and sizeable response to help the economy remain anchored. And this is exactly what we've seen by the Federal Reserve and the Bank of Canada in recent days.

The less firing power you have, the more important it is to react promptly at the onset of a shock to limit negative financial and economic dynamics from taking root. It's precisely because you have fewer bullets that you must be quicker off the mark once an insidious shock is identified that has a serious risk of undermining confidence.

Of course, lower interest rates alone won't heal what ails the economy and financial markets. It's the pathway to keeping debt service ratios affordable during a period when incomes may become stressed. It is also the pathway to shore up household confidence at a time when economic and labor market insecurity is seeping in. Lower rates help maintain affordability and, as life returns to normal, incent spending in areas that have large positive economic multipliers and are good gauges for consumer confidence, like homes, renovations, vehicles and so forth.

Global central banks (and regulators) have many tools at their disposal to shore up confidence when liquidity and credit issues intensify. A recent coordinated move has been to lower stability or countercyclical capital buffers within financial institutions in order to free up capital for lending. Depending on who holds the pen on bank regulation, this was initiated by the Bank of England last Wednesday and by the Office of the Superintendent of Financial Institutions (OSFI) within Canada on Friday. The Bank of England estimates that this initiative will put £190 billion into play for loans at a time when there will be more pressing demand. OSFI estimates that figure could be as high as $300 billion for Canada. Table 1 shows the various responses by global central banks in recent weeks.

## 4. *What's the downside risks as interest rates globally hit the lower bound?*

There are many and we've addressed these in other publications. Of course, it's much easier to cut interest rates than raise them. Once this shock is in the rear-view mirror and economic momentum has carved a path back to its steady-state, central banks will have to normalize financial settings. This is always easier said than done. There are plenty of examples that show financial markets don't like it when the punch bowl is taken away. One of the most memorable was coined "tapper tantrum" in 2013, when the Fed communicated its desire to lean back from quantitative easing. Market anxiety sent the 10-year Treasury yield up by 100 basis points with a few months,

| Country | Monetary and Regulatory Responses |
|---|---|
| Australia | • Benchmark interest rate cut by 25 basis points (bps) to 0.5%<br>• Injection of $5.4B into the repo market |
| Canada | • Policy interest rate first cut by 50 bps to 1.25% and again cut by an additional 50bps to 0.75%<br>• Market liquidity injections through expansion of the bond buyback program and term repo operations<br>• Cut in domestic stability buffer by 1.25 ppts to 1.00% with no increase in the next 18 months<br>• Funding supoport for SMEs throught Bankers' Acceptance Purchase Facility |
| China | • 10 bps drop in interest rates on reverse repurchase agreements and medium-term lending facility loans<br>• 1-year and 5-year loan prime rates cut by 10bps and 5bps, respectively<br>• Net repo injections<br>• Increase in re-lending and re-discounting quotas targeted towards SMEs<br>• Dictating banks to issue loans to SMEs at favorable rates and an extension on loan repayments for certain SMEs<br>• Cut in targeted reserve requirement ratio, releasing $79B into the economy |
| Euro Area | • Additional longer-term refinancing operations (TLTROs)<br>• More favorable terms applied to the existing TLTRO III and targeted towards SMEs<br>• Additional quantitative easing worth US$134B with an emphasis on private sector debt<br>• Bank temporarily allowed to operate below their mandated capital levels |
| Japan | • $4.7B in short-term liquidity to banks and increase the purchase of exchange traded funds<br>• Purchase of government bonds worth $1.9B |
| United Kingdom | • Benchmark interest rates cut by 50bps to 0.25%<br>• Counter Cyclical Capital Buffer moved to 0%<br>• Term funding scheme for SMEs for one year amounting to more than $129B<br>• A freeze on banks' dividends and bonuses |
| United States | • Target range for the federal fund rate lowered by 50 bps to 1.00% – 1.25% and by another 100 bps to 0.0% – 0.25%<br>• Increase in quantitative easing by $700B ($500 Treasuries and $200 MBSs)<br>• Eliminating reserve requirements for depository institutions<br>• Interest on excess reserves cut by 50 bps to 1.1%<br>• Injection of up to $5.5T to the repo market until April |
| Canada, England, Euro Area, Japan, Switzerland & United States | • A coordinated response by central banks to enhance the provision of liquidity via the standing U.S. dollar liquidity swap arrangements by lowering the pricing on the swap the arrangement by 25 bps and by increasing the maturity of the US dollars offered. |

Source: TD Economics

creating much tighter financial conditions than warranted. However, as history has shown us, once an economy has a sturdy foundation, it can withstand these bouts of volatility as markets recalibrate to new policy settings.

### 5. *Won't low interest rates create or worsen a housing bubble?*

Quite possibly. However, this question is typically posed from Canadian clients rather than American. Stronger momentum in the U.S. housing market would be welcomed, since household leverage is low and not problematic. Homeownership rates are also low among the millennial generation compared to those who came before them.

The same is not true for a number of hotspot cities in Canada. However, the downside risks from the coronavirus on global and domestic activity outweigh those emanating from the housing sector. If business and household confidence gives way, the last thing to worry about is having too much demand. And, although they won't say it, we will: It's not the Bank of Canada's job to manage Toronto's housing market. This is best left to regulators and macroprudential policies like the mortgage qualification stress test.

The economic shock of the current magnitude requires putting faith in these institutions and policies to manage the risks around the credit quality of borrowers. And, it's not just a coronavirus impact that is hitting the Canadian landscape. This downdraft will be amplified by the recent collapse in oil prices. In fact, the latter will likely leave a longer lasting footprint on the landscape than the former.

### 6. *Will the deluge of government spending fuel a future debt crisis, particularly in Europe?*

This too may occur at a future date if governments don't credibly pivot to debt management once the current crisis period has passed. But for now, the priority is to provide maximum funding to the health care system to assist with the wellbeing of the nation. The second order is to smooth out the economic shock and, if we're lucky, avoid a harder landing of a formal recession that would only serve to deepen the hardship on the population. In turn, this outcome would gut government coffers to a far greater extent from the collapse in tax revenues and simultaneous increase in stabilizer spending, like unemployment insurance. The third order is to communicate a sustainable debt plan, typically benchmarked by a stable or declining debt-to-GDP ratio. But this is not easily done at this stage, given the financial needs of the population are rapidly evolving. Any estimations would be highly subjective.

The reality is that central banks, no matter the country, don't have a lot of room to lower interest rates. This requires them to lean more on other policy tools, which are far more effective when coupled with the power of fiscal policy to directly address the income shock occurring with businesses and households. Economists have been calling on governments for some time to take a more surgical hand at boosting economic growth. Supporting households and business during this containment phase of the virus is a better reason than any other we've seen in recent history. In addition, governments are so far taking a responsible approach. They are spending in very targeted ways to address pain-points in the economy with several temporary measures. In fact, financial markets have been rewarding governments when they announce meaningful initiatives with relief rallies occurring in equity, currency and credit markets. It's well understood that the hand of the government is critical to offering the solution to what ails the economy.

Both the U.S. and Canada have recently announced fiscal assistance of varying degrees in recent days. Canada's approach will be multi-faceted, with the intention to shore up households and businesses directly with loans and income supplements. For instance, Finance Minister Morneau announced a 'credit facility' program, $10 billion in size, to support Canadian small- and medium-sized businesses. This will facilitate accessing needed loans to shore up finances should they become strained from reduced revenue and operation constraints. On the household side, the government is waiving the mandatory one-week waiting period to access EI benefits and adjusting the EI work-share program to mitigate layoffs by allowing employees to share reduced hours and maintain income support. The government has made clear more initiatives will continue to roll out shortly, which we expect will include a broadening reach of income supports across the population and potentially tax deferrals or credits for the most vulnerable businesses. We would not even blink if initiatives amounting to 3% of GDP would come into play when the final tally is known.

The U.S. has been slower off the mark but made a good first step over the weekend to provide free virus testing and paid sick leave with reimbursement to businesses via a temporary tax credit. This should help mitigate both, layoffs in the near-term, and the spread of the virus by incenting individuals to stay at home when ill and not having to absorb the income loss. At the same time, the Small Business Administration (SBA) will offer low interest loans to businesses impacted by the virus. Other income relief came through the deferral of student debt interest payments with Federally held loans.

It's likely there will be more initiatives in the weeks ahead. The success of government programs requires speed and efficiency on decisions and execution. Time will be the judge, but failure on this front would increase the risk of credit events among businesses, which will cause the trickle down to job losses. Once those dynamics set in broadly, recession dynamics would take hold. Spending more on upfront, proactive government action is preferred to the latter.

### 7. *How can you evaluate the outlook during unprecedented times?*

Ay, there's the rub! First, let's be painfully transparent. The likelihood of hitting the point estimate on GDP growth over the next six months is remote. The goal here is to achieve a fair representation of depth and duration by triangulating several data points. This starts with the measurement and understanding of real time financial indicators, like the TD financial stress index. This helps with an understanding of transmission risks to the real economic data.

Then we'll need to layer in high frequency data, but not just official data. Indicators that show how behavior has changed on a week to week basis, such as box office receipts and online restaurant bookings, can give us an idea of the magnitude of the drop in services spending. Within the traditional indicators, high frequency domestic data is richer in the U.S. than in Canada. Several metrics like weekly initial jobless claims are helpful in gauge the extent of labor market deterioration or resilience.

The U.S. also has more timely metrics of at-risk consumer-oriented industries (restaurant services, public transportation, recreational services and hotel accommodations) through the monthly personal consumer expenditure reports that feed directly into GDP estimates. The Canadian data is more lagged and encompasses smaller, less representative samples of household behavior. The U.S. also has timely business sentiment surveys. In particular, the ISM indexes have proven to be good leading indicators and will be helpful in gauging supply chain effects within the manufacturing sector, and broader service-sector impacts.

At the same time, the experiences of China, South Korea and Italy offer up leading indicators for what's in store in North America. Although China and South Korea are already re-booting economic activity with the benefit of aggressive testing and quarantine measures, the U.S. performance seems to have more parallels to that of Italy, which was slower off the mark on testing and containment. If that country succeeds in rebooting its economy in the coming weeks, even partially, then we may expect similar results in North America. Ultimately, people need to feel confident to safely move around the country.

Lastly, central banks and governments have just started to implement policy changes, and time will be needed to monitor the transmission to credit markets and business/household behaviors before snapping to judgement. With all that, it won't be until the April-May timeframe that a clearer picture will emerge on how the second quarter is shaping up in terms of the depth of impact.

As you know, we are all in unchartered waters with respect to the degree of global and domestic impacts. This creates larger forecast error and requires ongoing adjustments in real time as information unfolds.