TD Economics

Dollars and Sense
Financial Markets Lean On Central Banks To Mitigate COVID-19 Fallout

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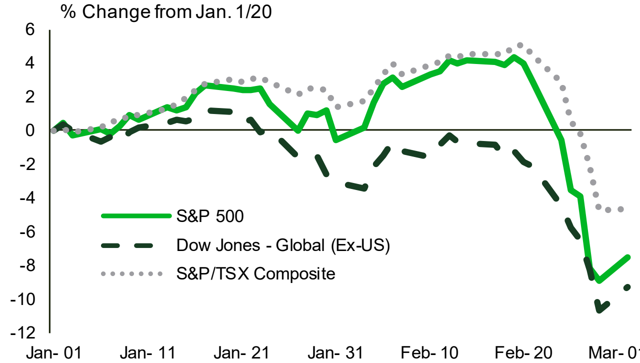
Highlights

- The spread of COVID-19 has shook financial markets. Equity indices have retraced about 15% from their peaks in late February, and government bond yields have fallen significantly on the repricing of policy rate expectations by major central banks.
- This week the Federal Reserve held an emergency policy meeting where it cut the fed funds rate by 50 basis points. The Bank of Canada has followed this lead with a 50 basis point cut, which surprised markets given the Bank's recent hesitation to easy policy in the face of weakening economic growth.
- The easing of policy rates and potential for fiscal stimulus are necessary in order to cushion the hit to economic growth due to the virus. There is significant growth at risk and the economic buffer in many economies is thin.
- Though this is a supply-side shock at its origin, a persistent undermining in sentiment can have demand-side impacts. This is where central banks have historically been quick to help. We expect further interest rate cuts by the Federal Reserve and the Bank of Canada at their March and April meetings, respectively.
- Central bank action to ease policy and ongoing uncertainty around the virus will keep sovereign bond yields, mortgage rates, and corporate borrowing costs at extraordinary low levels.

After the Group of Seven (G7) finance ministers made a unified statement that they are in a 'ready to act' position in response to the global COVID-19 outbreak, the Federal Reserve surprised markets with a 50 basis point cut to its policy rate. This impromptu meeting was unconventional but highlights the rapid shift in conditions over the past week, as confirmation that measures to contain the virus within China had failed. There are now over 80 countries with reported cases, some experiencing large-scale outbreaks. The broad reach creates greater opaqueness around potential global production and supply chain disruptions. Furthermore, market fear of this supply-side shock can morph into a demand-side shock if cautious behavior embeds deeply and persistently to undermine household and business confidence. The increased desire to save could trigger recession-like outcomes for countries that already sit on a thin growth cushion, resulting in deeper scars to the global economic landscape. Forward looking financial markets have responded to this potential economic loss with a strong risk-off move (Chart 1).

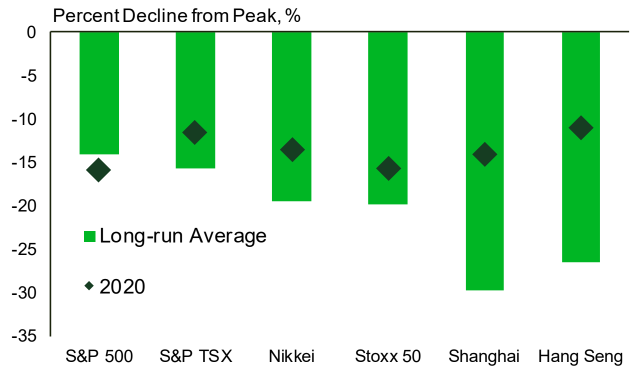
Chart 1: Equity Markets Rolling Over on COVID-19



Source: S&P, WSJ, TD Economics

Last week's rapid sell-off in equity markets is a demonstration on how quickly the foundation under sentiment can erode. It was less than two

Chart 2: The Equity Drawdown So Far



Source: Bloomberg, TD Economics

weeks ago that the S&P 500 hit an all-time high. In just seven trading days the Index declined approximately 15% peak-to-trough. Though the speed of the decline has been anomalous outside of recessions, the current sell-off from the peak is right around what typically occurs in any given year (Chart 2). For equity markets outside of the US, the drawdown started earlier, but has been just as pronounced.

The Safe Haven of the Bond Market

The Treasury market has been the biggest beneficiary of the risk-off environment. The UST 10-year has declined from 1.92% at the end of 2019, and is now below 1% today (Chart 3). This is reminiscent of the approximate 1% decline in response to the escalation of China-U.S. trade tensions last spring/summer. During that time, the expectation was that the Federal Reserve would respond to the economic risk by cutting interest rates. It did just that by cutting the policy rate by 75 basis points over three successive meetings from July to October 2019. The Federal Reserve's current response is even quicker and reminiscent of efforts to sure-up markets during past recessionary episodes. Money markets are expecting further action that would bring the policy rate well below 1%.

The Federal Reserve has shown a willingness to act when there are sustained deteriorations in market sentiment or deviations in global conditions from their expectations. Members of the Federal Reserve have been especially attuned to signals coming from the bond market. Even with the rate cuts this week, the yield on the UST 10-year is still below the effective fed funds rate. This inversion of the curve signals that investors think the Federal Reserve's policy rate is too high given the current economic environment.

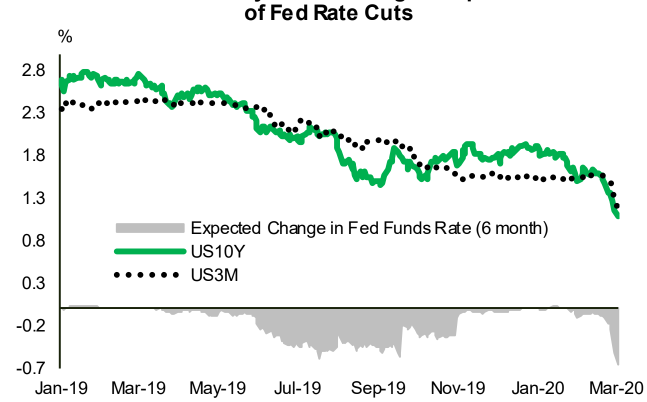
Our baseline view is that the Federal Reserve will cut the policy rate again at its scheduled meeting in March and look to see how the virus has evolved before cutting again at its meeting in late April. It is important to note that the U.S. economy continues to rest on a solid foundation, consistently outperforming peers by a wide margin. Any response to cut interest rates is to address the sentiment channel, not to address a clear-and-present danger on real economic activity.

The Bank of Canada has mirrored the response of the Federal Reserve with a 50 basis point rate cut this week. We expect it will continue to follow the Fed and cut again in April. We were pleased to see the Bank of Canada take such strong action in the face of such a large economic risk. Global growth estimates have deteriorated significantly, and the economy will suffer the sizable income shock from plummeting commodity prices. Even without an outbreak within a large urban center, economic activity will be whittled away through more cautious behavior to travel and attend activities. Their growth-at-risk framework argues for further cuts in the policy rate.

The Impact of Easier Monetary Policy

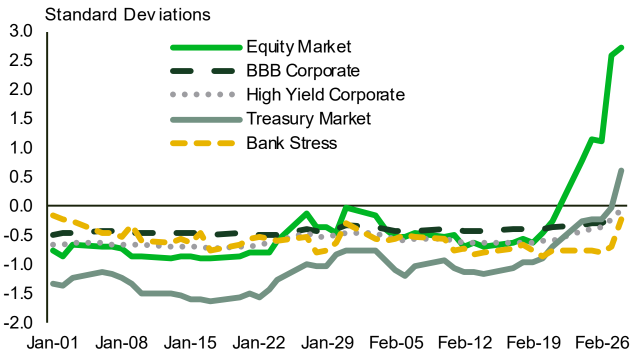
Let's face it, monetary policy is far more limited in addressing supply-side shocks, as we've noted in a recent report. Rate cuts will help ease debt service costs, which is meaningful given high debt loads. But it's unlikely to light a fire under the economy. The biggest near-term benefit occurs through the sentiment channel. The "do whatever it takes" mantra of central bankers

Chart 3: Treasury Yields Falling on Expectations of Fed Rate Cuts



Source: Bloomberg LP, TD Economics

Chart 4: Volatilty Elevated Most in Equities



*Last observation February 28,2020.
Source: WSJ, CBOE,ICE/BoAML, FRB, TD Economics

over the last three decades has supported investor confidence. Knowing that central banks will make efforts to stabilize the economy raises the probability of a quick recovery once the shock recedes. This also raises the probability that investment in risk assets will prove more profitable. In this way, central bank support can ease market tensions, to allow other areas of the economy to stabilize under the benefit of time or action of fiscal mechanisms. Our forecast for cuts to policy rates means that sovereign bond yields, mortgage rates, and corporate borrowing rates are all likely to hold lower.

Just How Stressed Are You?

When we run our financial stress models, we find that market stress has risen from very low levels in early 2020, to a 1 standard deviation level today. The stress is most apparent in equity markets, with volatility at 3 standard deviations (Chart 4). This is greater than during the equity market sell-offs of 2018 and 2015, and comparable to levels during the European sovereign debt crisis in 2011. On the other hand, indicators of stress within corporate credit, Treasury, and money markets have been much more muted. This infers that investors are pricing a hit to corporate profits (hence the repricing in equities) but are not yet pricing significant business or consumer defaults. In fact, outside of the lowest rated corporate borrowers, bond yields are closer to historical averages than before the sell-off. The same goes for US equity valuations, where forward looking price-to-earnings ratios have gone from elevated levels at the end of January, to levels that are much closer to historical averages today. In this way, it appears equities may have been primed for repricing.

Bottom Line

The spread of COVID-19 outside of China triggered a significant risk-off move in financial markets. Based on the information we have right now, our baseline view is that the economic fallout from this shock will reduce US and Canadian economic growth by about 0.5% to 0.7%. This number will grow based on the extent of the virus' geographic spread and whether fear changes peoples' day-to-day pattern (spending). With equity markets having corrected 15% last week, a significant economic shock was priced. Same goes for fixed income markets, where expectations for even lower policy rates has pushed bond yields lower.

The truth is that we don't know how bad this will get. What we do know is that some amount of economic growth is already at risk and supporting market confidence is key to mitigating that depth. It is likely the Federal Reserve and the Bank of Canada will continue to cut rates at their upcoming meetings. Should the economic outlook materially worsen from expectations, the Federal Reserve has about 1% in interest rate cuts available and is open to implementing unconventional monetary policies such as Quantitative Easing. The Bank of Canada has 1.25% in cuts until the zero floor is hit. But, we don't anticipate hitting either of these milestones. In a worst-case scenario, there's little doubt that central banks and governments would join forces to leverage policy tools to cushion the shock. As seen globally, governments within impacted regions are acting swiftly on the fiscal front, and we expect no less in North America.

For our regular readers, we want to let you know that we are closely watching the evolution of the virus and assessing the economic impact of the events. We will be providing regular updates to make sure you are aware of any material changes to our outlook.

To be continued…

Interest Rate Outlook													
	Spot Rate	2019				2020				2021			
	Mar-04	Q1	Q2	Q3	Q4	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
CANADA													
Overnight Target Rate	1.25	1.75	1.75	1.75	1.75	1.25	1.00	1.00	1.00	1.25	1.50	1.50	1.50
3-mth T-Bill Rate	1.14	1.67	1.66	1.65	1.66	1.02	0.90	0.90	1.02	1.27	1.40	1.40	1.40
2-yr Govt. Bond Yield	0.95	1.55	1.47	1.58	1.69	0.80	1.00	1.20	1.40	1.50	1.60	1.70	1.75
5-yr Govt. Bond Yield	0.90	1.52	1.39	1.40	1.68	0.80	1.10	1.30	1.50	1.60	1.70	1.80	1.85
10-yr Govt. Bond Yield	1.01	1.62	1.46	1.37	1.70	0.90	1.25	1.45	1.65	1.75	1.85	1.95	2.00
30-yr Govt. Bond Yield	1.31	1.89	1.68	1.53	1.76	1.20	1.40	1.60	1.80	2.00	2.10	2.20	2.25
10-yr-2-yr Govt Spread	0.07	0.07	-0.01	-0.21	0.01	0.10	0.25	0.25	0.25	0.25	0.25	0.25	0.25
U.S.													
Fed Funds Target Rate	1.25	2.50	2.50	2.00	1.75	1.00	1.00	1.00	1.00	1.25	1.50	1.75	2.00
3-mth T-Bill Rate	0.71	2.35	2.08	1.84	1.52	0.85	0.85	0.85	0.98	1.23	1.48	1.73	1.98
2-yr Govt. Bond Yield	0.69	2.27	1.75	1.63	1.58	0.60	0.90	1.20	1.50	1.80	2.10	2.30	2.40
5-yr Govt. Bond Yield	0.78	2.23	1.76	1.55	1.69	0.70	1.00	1.30	1.60	1.90	2.20	2.40	2.50
10-yr Govt. Bond Yield	1.05	2.41	2.00	1.68	1.92	0.85	1.15	1.45	1.75	2.05	2.35	2.55	2.65
30-yr Govt. Bond Yield	1.70	2.81	2.52	2.12	2.39	1.50	1.80	2.00	2.20	2.40	2.60	2.80	2.90
10-yr-2-yr Govt Spread	0.36	0.14	0.25	0.05	0.34	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
CANADA - U.S SPREADS													
Can - U.S. T-Bill Spread	0.43	-0.68	-0.42	-0.19	0.14	0.17	0.05	0.05	0.04	0.04	-0.08	-0.33	-0.58
Can - U.S. 10-Year Bond Spread	-0.04	-0.79	-0.54	-0.31	-0.22	0.05	0.10	0.00	-0.10	-0.30	-0.50	-0.60	-0.65

F: Forecast by TD Economics, March 2020; Forecasts are end-of-period.
Source: Bloomberg, Bank of Canada, Federal Reserve.

Foreign Exchange Outlook														
Currency	Exchange rate	Spot Price	2019				2020				2021			
		Mar-04	Q1	Q2	Q3	Q4	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Exchange rate to U.S. dollar														
Chinese Yuan	CNY per USD	6.93	6.71	6.87	7.15	6.96	6.95	6.90	6.85	6.80	6.80	6.80	6.80	6.80
Japanese yen	JPY per USD	108	111	108	108	109	105	106	106	105	105	104	104	103
Euro	USD per EUR	1.11	1.12	1.14	1.09	1.12	1.09	1.09	1.10	1.11	1.12	1.13	1.14	1.15
U.K. pound	USD per GBP	1.29	1.30	1.27	1.23	1.33	1.28	1.28	1.30	1.31	1.32	1.33	1.34	1.35
Swiss franc	CHF per USD	0.96	1.00	0.98	1.00	0.97	0.97	0.97	0.97	0.97	0.97	0.97	0.97	0.97
Canadian dollar	CAD per USD	1.34	1.34	1.31	1.32	1.30	1.36	1.36	1.34	1.32	1.31	1.30	1.30	1.30
Australian dollar	USD per AUD	0.66	0.71	0.70	0.68	0.70	0.64	0.66	0.68	0.69	0.70	0.70	0.70	0.70
NZ dollar	USD per NZD	0.63	0.68	0.67	0.63	0.68	0.62	0.64	0.65	0.66	0.67	0.68	0.69	0.69
Exchange rate to Euro														
U.S. dollar	USD per EUR	1.11	1.12	1.14	1.09	1.12	1.09	1.09	1.10	1.11	1.12	1.13	1.14	1.15
Japanese yen	JPY per EUR	120	124	123	118	122	114	116	116	117	117	118	118	119
U.K. pound	GBP per EUR	0.87	0.86	0.90	0.89	0.85	0.85	0.85	0.85	0.85	0.85	0.85	0.85	0.85
Swiss franc	CHF per EUR	1.07	1.12	1.11	1.09	1.09	1.06	1.06	1.06	1.07	1.08	1.09	1.10	1.11
Canadian dollar	CAD per EUR	1.49	1.50	1.49	1.44	1.46	1.48	1.48	1.47	1.47	1.47	1.47	1.48	1.50
Australian dollar	AUD per EUR	1.68	1.58	1.62	1.62	1.60	1.70	1.65	1.62	1.61	1.60	1.61	1.63	1.64
NZ dollar	NZD per EUR	1.77	1.65	1.70	1.74	1.67	1.76	1.70	1.69	1.68	1.67	1.66	1.65	1.67
Exchange rate to Japanese yen														
U.S. dollar	JPY per USD	108	111	108	108	109	105	106	106	105	105	104	104	103
Euro	JPY per EUR	120	124	123	118	122	114	116	116	117	117	118	118	119
U.K. pound	JPY per GBP	138	144	137	133	144	134	136	137	138	138	138	139	139
Swiss franc	JPY per CHF	112.4	111.1	110.5	108.3	112.3	108.5	109.5	109.0	108.5	108.0	107.5	107.0	106.7
Canadian dollar	JPY per CAD	80.3	82.8	82.4	81.6	83.8	77.2	77.9	78.7	79.5	79.8	80.0	79.6	79.4
Australian dollar	JPY per AUD	71.3	78.6	75.6	72.9	76.4	67.2	70.0	71.7	72.5	73.2	72.8	72.5	72.3
NZ dollar	JPY per NZD	67.7	75.5	72.4	67.7	73.3	65.1	67.8	68.6	69.3	70.0	70.7	71.4	71.2
Exchange rate to Canadian dollar														
U.S. dollar	USD per CAD	0.75	0.75	0.76	0.76	0.77	0.74	0.74	0.75	0.76	0.76	0.77	0.77	0.77
Japanese yen	JPY per CAD	80.3	82.8	82.4	81.6	83.8	77.2	77.9	78.7	79.5	79.8	80.0	79.6	79.4
Euro	CAD per EUR	1.49	1.50	1.49	1.44	1.46	1.48	1.48	1.47	1.47	1.47	1.47	1.48	1.50
U.K. pound	CAD per GBP	1.72	1.74	1.66	1.63	1.72	1.74	1.74	1.74	1.73	1.73	1.73	1.74	1.76
Swiss franc	CHF per CAD	0.71	0.75	0.75	0.75	0.75	0.71	0.71	0.72	0.73	0.74	0.74	0.74	0.74
Australian dollar	AUD per CAD	1.13	1.05	1.09	1.12	1.10	1.15	1.11	1.10	1.10	1.09	1.10	1.10	1.10
NZ dollar	NZD per CAD	1.19	1.10	1.14	1.21	1.14	1.19	1.15	1.15	1.15	1.14	1.13	1.11	1.11

F: Forecast by TD Economics, March 2020; Forecasts are end-of-period.
Source: Federal Reserve, Bloomberg.

International Interest Rates Outlook

	Spot Rate Mar-04	2019 Q1	2019 Q2	2019 Q3	2019 Q4	2020 Q1F	2020 Q2F	2020 Q3F	2020 Q4F	2021 Q1F	2021 Q2F	2021 Q3F	2021 Q4F
Germany													
ECB Deposit Rate	-0.50	-0.40	-0.40	-0.50	-0.50	-0.60	-0.70	-0.70	-0.70	-0.70	-0.70	-0.70	-0.70
3-mth T-Bill Rate	-0.65	-0.55	-0.60	-0.61	-0.73	-0.65	-0.70	-0.70	-0.70	-0.70	-0.70	-0.70	-0.70
2-yr Govt. Bond Yield	-0.84	-0.61	-0.76	-0.78	-0.62	-0.75	-0.70	-0.59	-0.58	-0.54	-0.51	-0.46	-0.40
5-yr Govt. Bond Yield	-0.83	-0.46	-0.67	-0.78	-0.48	-0.75	-0.70	-0.60	-0.48	-0.44	-0.41	-0.36	-0.30
10-yr Govt. Bond Yield	-0.64	-0.07	-0.33	-0.58	-0.19	-0.60	-0.55	-0.45	-0.33	-0.29	-0.26	-0.21	-0.15
30-yr Govt. Bond Yield	-0.16	0.57	0.26	-0.10	0.31	-0.15	-0.12	-0.10	-0.08	-0.04	-0.01	0.04	0.10
10-yr-2-yr Govt Spread	0.20	0.54	0.43	0.20	0.43	0.15	0.15	0.14	0.25	0.25	0.25	0.25	0.25
United Kingdom													
Bank Rate	0.75	0.75	0.75	0.75	0.75	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
3-mth T-Bill Rate	0.46	0.75	0.75	0.77	0.70	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
2-yr Govt. Bond Yield	0.20	0.64	0.68	0.36	0.54	0.25	0.20	0.30	0.42	0.46	0.63	0.75	0.85
5-yr Govt. Bond Yield	0.25	0.69	0.61	0.28	0.60	0.33	0.40	0.53	0.66	0.73	0.86	0.98	1.07
10-yr Govt. Bond Yield	0.37	0.99	0.83	0.40	0.73	0.40	0.60	0.75	0.90	1.00	1.10	1.20	1.30
30-yr Govt. Bond Yield	0.90	1.55	1.47	0.98	1.33	0.90	1.15	1.25	1.35	1.45	1.55	1.65	1.75
10-yr-2-yr Govt Spread	0.17	0.36	0.15	0.05	0.19	0.15	0.40	0.45	0.48	0.54	0.48	0.45	0.45

F: Forecast by TD Economics, March 2020; Forecasts are end-of-period.
Source: Bloomberg.

Global Stock Markets

	Price Mar-04	30-Day % Chg.	YTD % Chg.	52-Week High	52-Week Low
S&P 500	3,130	-3.0	-2.8	3,386	2,743
S&P/TSX Composite	16,780	-3.1	-1.9	17,944	15,996
DAX	12,128	-6.6	-9.1	13,789	11,347
FTSE 100	6,816	-6.5	-10.2	7,687	6,581
Nikkei	21,100	-9.1	-11.5	24,084	20,261
MSCI AC World Index*	536	-4.0	-5.0	581	492

*Weighted equity index including both developed and emerging markets.
Source: Bloomberg, TD Economics.

Commodity Price Outlook

	Price Mar-04	52-Week High	52-Week Low	2019 Q1	2019 Q2	2019 Q3	2019 Q4	2020 Q1F	2020 Q2F	2020 Q3F	2020 Q4F	2021 Q1F	2021 Q2F	2021 Q3F	2021 Q4F
Crude Oil (WTI, $US/bbl)	47	66	45	55	60	56	57	51	49	56	58	58	59	59	60
Natural Gas ($US/MMBtu)	1.83	2.96	1.75	2.92	2.56	2.38	2.40	1.90	1.85	2.20	2.30	2.40	2.41	2.42	2.44
Gold ($US/troy oz.)	1637	1659	1271	1303	1307	1473	1482	1605	1675	1625	1575	1550	1525	1500	1475
Silver (US$/troy oz.)	17.22	19.60	14.35	15.58	14.91	17.02	17.34	17.70	18.50	18.00	17.85	17.75	17.65	17.50	17.25
Copper (cents/lb)	257	297	250	282	278	263	267	261	256	277	288	280	277	278	281
Nickel (US$/lb)	5.75	8.19	5.27	5.60	5.56	7.05	6.99	5.86	5.75	6.24	6.35	6.69	6.80	7.03	7.26
Aluminum (Cents/lb)	78	88	76	84	81	80	80	77	75	78	78	78	78	77	77
Wheat ($US/bu)	6.67	7.55	5.62	7.08	6.36	6.14	6.77	6.64	6.55	6.80	6.90	6.92	6.93	6.95	6.97

F: Forecast by TD Economics, March 2020; Forecast are period averages; E: Estimate.
Source: Bloomberg, USDA (Haver).