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ASSESSING THE MARKET PANIC

Berenberg Macro Flash

Financial markets sometimes take on a life of their own. As in other spheres of human behaviour, fear can beget fear. After the US Fed cut its Fed funds rate by 50bp on 4 March, markets ended the day sharply lower. After the ECB announced big liquidity injections yesterday, markets sold off even more badly. Although the ECB raised its bond purchase programme by €120bn yesterday, yield spreads widened nonetheless. The ECB's failure to cut its deposit rate by 10bps cannot really justify such a dramatic shift in market valuations, at least not in a fundamental sense. Markets are in panic mode, focussing on negative interpretations of events rather than the full picture.

ECB out of ammunition? Not really

One example for that negative skew is the fear that, with its failure to cut the deposit rate from -0.5% to -0.6% and raise the issuer/issuance limits for bond purchases, the ECB may have signalled that it has hit the lower bound for rates and run out of ammunition. We do not share that view:

1) The ECB can increase both corporate and sovereign **bond purchases**, as it announced yesterday. Sadly, the Eurozone recession will add to the supply of bonds the ECB can buy even without changing its 33% issuer/issuance limits.
2) The negative interpretation focuses too much on the ECB's **deposit rate** and a careless comment about bond spreads. The main task of a central bank is not to absorb surplus liquidity but to provide the banking system with liquidity in the first place. With its new and very generous conditions for its long-term liquidity injections, available now to banks under certain conditions at a rate that can be as low as -0.75%, the ECB de facto cut the rate at which it injects its money into the system. Unfortunately, the ECB failed to sell this as what it is, a de facto **cut in its effective lending rate** that may be more relevant than any reduction in its deposit rate might have been.
3) The ECB itself emphasised that it may use **other policy levers** if required.
4) In the broadest sense, a central bank is never out of ammunition as long as people are ready to accept and hold the money which the central bank prints. As the Bank of Japan has shown, that can include purchases of equities. The hurdle to buy exchange-traded funds is high for the ECB. For the ECB, the equity market is less important than the bond market as a transmission channel for its monetary policy. But the ECB has shown in the past that in can break previous taboos if need be.

In panic mode

For now, markets are in panic mode. Panics are vicious but temporary. At some point, enough people will realise that, whatever the initial trigger, the selloff has gone too far and hold against it. Economists cannot predict when and how such a point will be reached. Against a panic reaction to a severe and worsening medical emergency, even huge monetary and fiscal stimuli are not obvious circuit breakers. That makes it even more difficult for economists to gauge how far the panic may go. All we can assess is whether, on any half-reasonable scenario for the future, the current massive re-rating of equities makes fundamental sense. In my view, it does not. Unfortunately, it will take time for the uncertainty about the course of the pandemic and the reaction to it to recede.

Consider the economics of two hypothetical extreme cases. First, the virus continues to spread fast so that, within a year, so many citizens of advanced countries have had the - usually mild - disease that the pandemic subsides on its own because most people have become immune to it. Or, second, the advanced world goes into a three-month lockdown to slash the infection rate Chinese style. It would happen over a more extended period than in China, though, as democracies would not enforce such a lockdown quite as strictly. In both extreme cases, the economic damage on top of the much more relevant human costs would be huge, either on a rolling basis over a year (extreme scenario one) or concentrated on one quarter (extreme scenario two).

Quantifying the potential economic losses during the rolling or concentrated lockdown is near impossible. Some activities would cease for a while. However, major parts of the public sector would carry on, with schools and universities among the exceptions. The health sector would work overtime. Parts of modern services would migrate into the virtual world, including – presumably – accountants, tax advisors and financial analysts. Many losses, especially in instantly consumable services, would be permanent but largely one-off. In other sectors, a significant part of the production losses could be recovered once supply chains have been restored. Pent-up demand for industrial goods, construction or even fashion items would likely meet a post-crisis desire to work overtime once the worst is over.

In either of these two hypothetical extreme scenarios, many costs would likely migrate to governments. Supported by extremely expansionary monetary policies, governments would provide near unprecedented help to companies, workers and consumers to contain the risks of widespread bankruptcies, dismissals and of a systemically relevant wave of credit defaults.

Neither of these extreme scenarios would change our assessment that the pandemic is a temporary shock. Once the worst is over, companies as well as their workers and their non-human assets would be ready to return to normal over time. It seems highly unlikely that the productive capital of the private economy, as valued by equity prices, would really have lost 20% or more of its value in the end relative to the start of 2020.

When the rebound starts, it will almost certainly do so in an environment in which bond yields will be much lower for even longer than they would have been otherwise. That will make post-corona dividend yields look even more attractive. Also, a good part of the monetary and fiscal stimulus that would be employed in either of the extreme scenarios would still be in the pipeline. Low bond yields would make it easier for governments to bear the extra debt burden without having to hike taxes by much in the first years after the crisis. As a little bonus, lower oil prices may also bolster the real purchasing power of consumers.

I use these hypothetical extreme cases not as predictions. They are tail risk scenarios meant to illustrate that, even under extreme assumptions about the pandemic, it seems unreasonable to expect a permanent re-rating of equities to such an extent as the current market rout would suggest.

More room to act if need be

In such hypothetical bad case scenarios, policy would likely react more forcefully than it is doing at the moment. Over time, current taboos could then be breached. More extreme policy responses could potentially include:

- ECB purchases of equities in the form of exchange traded funds;
- a serious increase in issuer limits for its bond purchases; and
- almost perpetual long-term loans or other variants of “helicopter money”.

Separately, governments may inject serious amounts of public money into a significant number of non-financial (and financial) companies to keep them going.

That the ECB did not go for extreme options yesterday is not a sign that it never would. Instead, it shows that, in the ECB’s judgment yesterday morning, the situation did not require such measures yet. Of course, that assessment may change in response to circumstances.

If necessary, the European Stability Mechanism and the ECB would have the tools to address potential negative feedback loops between banks and sovereigns. In the US, the Fed and other agencies would act decisively if a limited debt shake-out in the shale oil sector threatened to morph into a big macroeconomic calamity.

The Covid-19 shock has pushed the Eurozone into a recession. But as in the case of previous recessions, markets should eventually look through the severe near-term risks and recover the losses eventually. However, we may first need a better idea of how the pandemic will play out before markets can turn up again for good.

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