Financial Markets & the Fed in the COVID-19 Pandemic

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COVID-19, GLOBAL MARKETS &
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Financial Markets and the Fed in the COVID-19 Pandemic

HBS finance faculty members led a discussion about how the financial markets have been disrupted by COVID-19, the Federal Reserve's response, and implications of this response.

Professor Robin Greenwood focused on the equity markets and was joined by panelists David Abrams of Abrams Capital and HBS professor emeritus André Perold of HighVista Strategies. Professor Adi Sunderam examined the bond markets, along with panelists Sir Paul Tucker of Harvard's Kennedy School, who chairs the Systemic Risk Council, and Boaz Weinstein of Saba Capital Management. Professor Victoria Ivashina looked at corporate liquidity.

Equity Markets

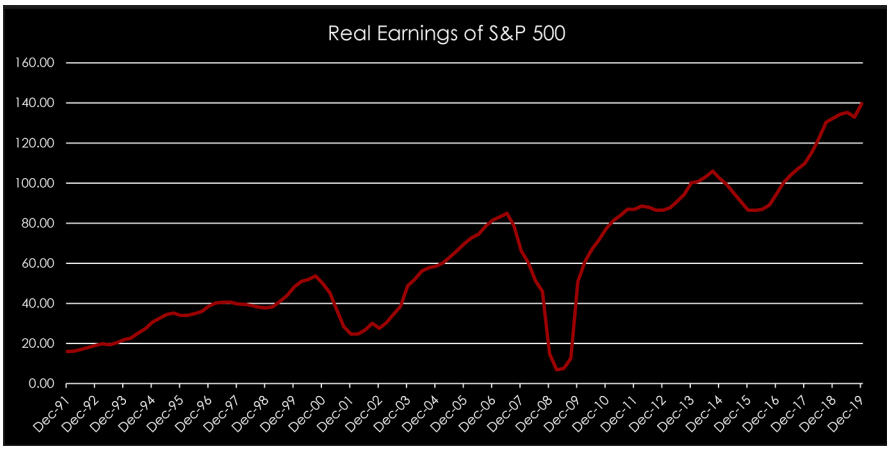
From its peak in February 2020 to its trough in mid-March, the S&P 500 declined by 34%. However, as of this program (April 14, 2020), the S&P had rebounded to only be down by 18%. Global markets have been highly correlated. Returns have been negative in all sectors, particularly energy and finance.

While near-term financial measures are negative, it is important to keep in mind the present value formula: an asset's price is the discounted value of future cash flows. What matters are the cash flows and the discount rate.

For an asset where the cash flow grows 3-5% per year, with a discount rate of 8-10%, the current year only represents 3-6% of the total value. Thus, the current year's impact on long-term value is small. Therefore, making sense of the markets is not necessarily about what is happening today but about what will happen in the future.

In looking at previous slowdowns in 2000-02 and 2008-09, earnings of the S&P bounced back relatively quickly.

Figure 1: Real Earnings of the S&P 12/91 to 12/19 (Source: Robert Shiller)



MAIN IDEAS

- **The equity and bond markets have been and remain extremely turbulent. Volatility, uncertainty, and risk remain high.**
- **The markets are looking past the present and are largely focused on the future—though tremendous uncertainty remains about the duration of the pandemic.**
- **For investors it is a time to be cautious and focus on what you know but be willing to pounce on obvious and significant opportunities.**
- **The speed and magnitude of the Fed's interventions are unprecedented. The Fed has helped stabilize the markets but some actions raise questions about the Fed's role.**

> "Near-term cash flow news is extremely negative, but markets have already started to look beyond this year."
>
> Robin Greenwood

The panelists see this as an unprecedented systemic event with tremendous uncertainty, risk, and unknowns. The unknowns include how deep the economic downturn will be and how long it will last. The level of uncertainty and risk is reflected in the VIX, an index of volatility. As of this program, the VIX was three times higher than in February 2020.

André Perold sees the Fed's astounding reaction as adding to the uncertainty. He stated, "Every time the Fed acts, you know they're acting because they're afraid . . . they're panicked."

> **"If the Fed is willing to go to such lengths, be careful of what they are signaling."**
> André Perold

In looking at the equity markets, the panelists shared the following thoughts:

- Try to own companies that will be healthy regardless of the depth and length of the downturn.
- Make bets on owning companies you believe will make it to 2022 or 2023 and not go bankrupt.
- Invest in areas where you are knowledgeable and comfortable.
- Have a high hurdle rate; don't invest in marginal opportunities. Only put cash to work in the best places and have more left for other dislocations.
- Be alert to opportunities and mispricing of risk. When market indices were down 30%, some individual stocks were down 50% to 70% and some bonds were off 50 points. In that environment, there are opportunities.
- Because this is a systemic event, it affects everything—your life, family, job, and portfolio. When something is systemic, be more cautious than otherwise.

> **"Nobody knows how companies are going to do this year. We don't have much sense as to next year . . . so try to buy and own things based on what it will look like in 2022 or 2023."**
> André Perold

Bond Markets and the Fed

There has been tremendous chaos in the bond markets.

- Yields on US Treasuries are near zero, at all-time lows.
- Credit spreads have soared as investment-grade spreads have more than doubled from below 2% in early March to around 4.5% in April; high-yield spreads increased from around 4% to around 10% during this time as markets are anticipating more defaults.
- Around $150 billion has flowed out of corporate bond funds.
- High-yield bond issuances, an important source of financing for many firms, have collapsed.

In response, the Fed has deployed its entire playbook. But compared to 2008-09 when deploying this playbook took almost a full year, this time it took two weeks.

> **"What is surprising is the speed and aggression the Fed has shown."**
> Adi Sunderam

The Fed's playbook includes cutting the federal funds rate to zero, quantitative easing by buying about $1.2 trillion in treasuries, providing liquidity support to various types of financial institutions, and—in a new and unprecedented move—supporting credit markets directly by buying investment-grade bonds, municipal bonds, and possibly high-yield bonds.

The panelists agreed that the Fed's actions don't affect firms' cash flows but have kept businesses open that might have gone bankrupt. These bond experts said conditions in the credit markets are remarkably buoyant given the shock to the economy. They expressed concern about the Fed acting in ways usually reserved for the US Treasury, which raises questions about the Fed's future role, but those questions will have to wait until after the crisis.

As with the equity panelists, these panelists have seen panic in the markets and mispricing of risk, presenting opportunities. Boaz Weinstein mentioned an ETF of investment-grade and high-yield municipal bonds briefly priced at a 27-point discount to its NAV; the next day it rebounded to a 4-point discount. There are attractive opportunities for calm, analytical investors with dry powder.

Corporate Liquidity

Many companies with corporate debt face significant challenges. Even before the COVID-19 crisis there was an unprecedented amount of corporate leverage. Now, COVID-19 has created enormous, urgent liquidity needs as widespread downgrades are occurring.

Companies with collateralized loan obligations (CLOs) face a roadblock in trying to access additional capital. Current creditors are the most obvious source of capital, but many are unwilling to provide additional capital and CLO covenants restrict equity investments.

A potential solution is private capital, which is abundant but is not flowing to this space. To address the demands for capital by midcap firms, the government is writing a huge check and providing a pure bailout as opposed to creating incentives for private capital. Victoria Ivashina sees better ways to spend taxpayers' dollars than just signing checks in a rush; she believes there is still room for better design of government assistance.

Additional Resources

- View the video and download the slides from this program
- See the HBS Coronavirus Economic Tracker, a website developed by HBS tracking economic activity and global policy
- Read Victoria Ivashina's recent HBR article "Managing the Liquidity Crisis"

"What are the authorities trying to do? I think they are simply trying to keep the market economy in existence."
Paul Tucker

"There's a lot of things that are highly unusual."
Boaz Weinstein

"Some of the [CLO] structures are not created to supply capital to companies that might be in temporary distress."
Victoria Ivashina

"I strongly disagree that this [the CARES Act] is the right solution, in particular because it does not leverage the private capital that is already there. . . it is a bailout in its pure form."
Victoria Ivashina