

Market Bulletin

March 4, 2020

From COVID to QE

In brief

- The March rate cut brings the Reserve Bank of Australia (RBA) into striking distance of the effective lower bound for rates in Australia.
- A weaker domestic demand profile further impacted by the disruptions from the COVID-19 virus means that economic targets around the unemployment rate or inflation rate are unlikely to be achieved, implying further easing to come.
- The chance of the RBA engaging in quantitative easing (QE) has risen, but the balancing act between stimulating the economy and avoiding financial instability is a delicate one.

Central banks are once again acting to steady volatile markets in the wake of the widening economic impact from the COVID-19 virus. In Australia, the weakness in domestic demand and failure of the three rates cuts last year to lift corporate and consumer sentiment had already created a case for further easing by the RBA this year, the COVID-19 virus just accelerated the process.

At the March meeting the RBA cut rates by 25 basis points and represents a prudent move to address uncertainty given the vast number of unknowns about the virus and how fast and far it could spread, while acknowledging that it will further dampen already subdued domestic activity.

MORE TO COME

The RBA is ready to act again if needed, and at the time of writing the potential for another rate cut in the coming months is high. However, the nature of the COVID-19 outbreak remains fluid with a variety of possible outcomes. Containment could be achieved in a matter of weeks, or the viral infection may spread further with wider ranging control measures and disruptions to economic activity.

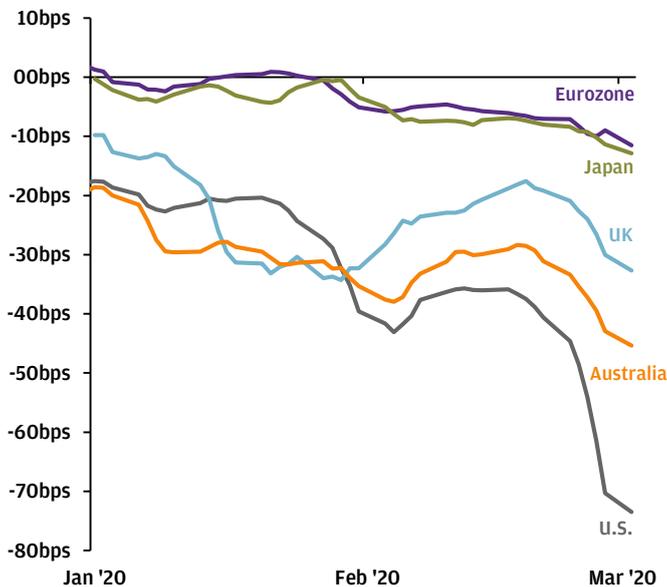
While the path for monetary policy is not set, a strong downward bias will remain until there is greater clarity over the viral infection. This means that the RBA is fast approaching what is widely thought to be the lower bound for the cash rate at 0.25%.



Kerry Craig
Global Market Strategist

Unconventional policies may be implemented this year, especially as the economy outside of the housing market has been slow to respond to the 75 basis points of cuts last year and the new economic risks from the COVID-19 virus.

Markets have been aggressive in pricing easier monetary policy
EXHIBIT 1: MARKET PRICING OF EASING FOR POLICY RATE CHANGES BY 2020 YEAR-END
 BASIS POINTS, 5-DAY MOVING AVERAGE



Source: Bloomberg, J.P. Morgan Asset Management. Data as of March 3, 2020.

Statements such as “If we are not achieving our objectives, then we have a mandate to try and achieve our objectives” suggest the RBA isn’t opposed to using the unconventional. Although, the experience of the world’s biggest central banks shows that extreme monetary stimulus has failed to boost growth and inflation rates. As a new cycle of easing starts there are many questions about how effective policy can be from already low or negative rates.¹

Easing policy from already low rates has a diminishing positive impact on the real economy and the risk of falling into the liquidity trap rises. This is a situation where the benefits of lower interest rates are not transmitted to the economy due to signalling effects, regulatory constraints or reduced pass through from retail banks.²

The nature of the shock to the economy matters as well. The RBA’s actions are designed to mitigate market and corporate uncertainty, as well as alleviating any corporate and household debt burdens in the face of slower economic

growth. At best this will cushion the blow from the viral spread but cannot stop it. As powerful as central bank have become in the eyes of the markets, they cannot reopen or increase production in factories in China or anywhere.

The government is more receptive to spending but action appears limited. The bushfires that gripped the country during the summer combined with the unknown impact of the viral spread have increased the chance of a boost to the economy in the May Budget. However, it is not clear at this stage just how significant any fiscal stimulus will be, and it will be determined by the pace of the viral spread between now and Budget day.

More than just bond buying

Unconventional monetary policy is not just the purchase of bonds and the RBA has deviated from the traditional. In the last few years forward guidance became prevalent and explicit. Tying the outlook for rates to the unemployment rate was the latest means to provide a sign post for how the interest rates may move.

Negative rates appear a step too far for the RBA based on speeches from Governor Lowe and a view that unconventional policies would be implemented before rates reach zero.³ The focus turns to bond purchases or provisions of loans to banks, both areas where it is possible to draw on international experience.

Different strokes for different folks

The outright goal of quantitative easing is the same everywhere, to drive down rates and stimulate the economy. However, the means to achieve that goal shapes how the QE program may look. In the U.S. QE came on the back of a housing-led recession. The U.S. Federal Reserve wanted to drive down mortgage rates and heal a damaged housing market. Meanwhile, in the eurozone the European Central Bank (ECB) needed to address a fractured banking system and austere government fiscal policies. A by-product in both the U.S. and eurozone has been to weaken the currency.

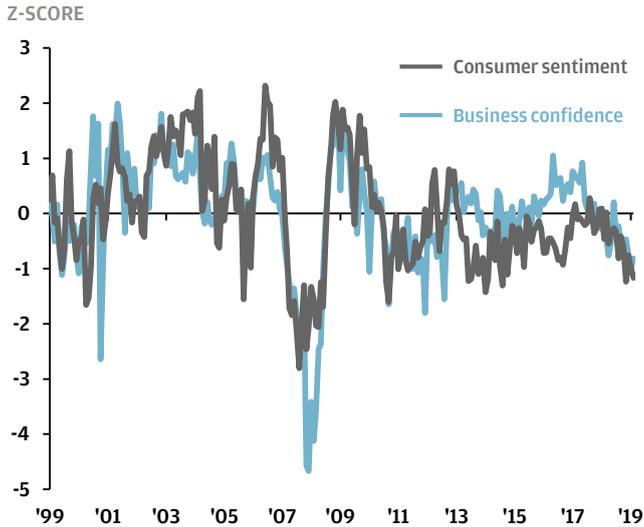
For the RBA, the challenge remains balancing the stimulus needed to offset the weak domestic demand caused by low wage growth and frail business investment that may be exacerbated by the COVID-19 spread without heightening financial instability, particularly in the housing market.

¹ The diminished stimulatory impact of monetary policy is explored more in the thematic paper “The failure of monetary stimulus” included in the 2020 Long-Term Capital Market Assumptions publication.

² The liquidity trap is a situation where interest rates are consistently lowered but with diminishing impact on boosting economic activity.

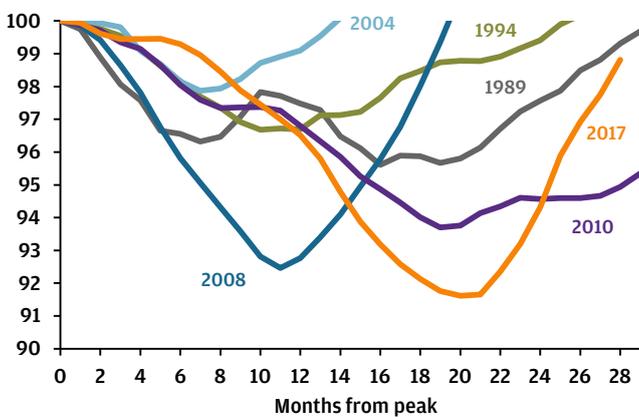
³ “...it is extraordinarily unlikely that we will see negative interest rates in Australia.” RBA Governor Lowe, Some Echoes of Melville speech, 29 October 2019.

Successive rate cuts have failed to lift corporate and consumer spirits
EXHIBIT 2: CONSUMER SENTIMENT AND BUSINESS CONFIDENCE



Source: FactSet, National Australia Bank, Westpac, J.P. Morgan Asset Management. Data as of March 3, 2020.

National house prices have nearly returned to 2017 peak
EXHIBIT 3: HOUSE PRICES IN DIFFERENT CYCLES
 INDEXED TO 100 AT PEAK, NATIONAL DWELLING PRICES



Source: RPD CoreLogic, J.P. Morgan Asset Management. Data as of March 3, 2020.

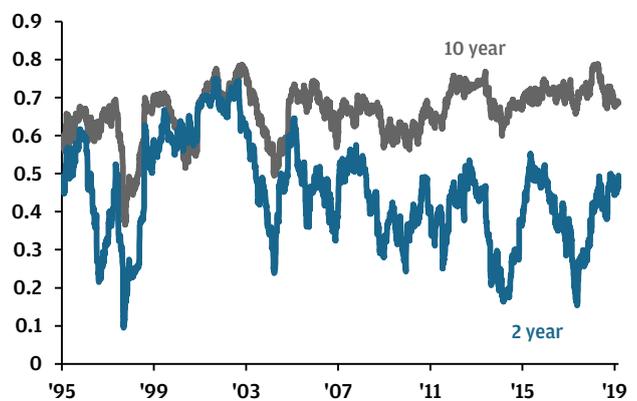
Keep it simple

In the event that it does pursue QE, the RBA is likely to pursue as straight forward expansion of the balance sheet through the open-ended purchase of Australian government bonds until there are more tangible signs of economic stability and persistent inflationary pressures. The smaller size of the Australian bond market means that a relatively small share of the bond market could be purchased to start to have a meaningful impact. The value of outstanding Australian Government Bonds is approximately AUD660 billion and the RBA could run a quarterly purchase program between AUD10-20 billion per quarter to lower borrowing costs for households, companies and create some depreciation of the Australian dollar to boost trade.

By focusing on the shorter to middle duration bonds, the RBA could improve the transmission effect to households via retail banks given the higher proportion of variable rate mortgages that are linked to the shorter end of the yield curve. Meanwhile, falling risk-free rates and tighter credit spreads from portfolio rebalancing would bring down corporate borrowing costs.

Global forces often dictate the direction of yields on longer dated bonds. Over time we've seen the impact of lower rates and lower yields in the U.S. push down yields in Australia. Similarly, the practices of the ECB have created an anchor over just how far U.S. Treasuries could rise when the U.S. economy was looking relatively stronger. In the current environment of lower rates and subdued global growth, international pressure may help in keeping local rates low.

Global forces have greater influence over long dated bond yields
EXHIBIT 4: 2- AND 10-YEAR AUSTRALIA - U.S. BOND CORRELATIONS
 ROLLING 1-YEAR CORRELATION



Source: FactSet, Tullet Prebon, J.P. Morgan Asset Management; data as of March 2, 2020.

Australia's historic position as a 'high yielder' in the government bond market means that there is a relatively high level of foreign ownership of Australian government debt. A little over 55% of outstanding bonds are held by foreign investors and increased selling pressure should lead to a depreciation in the Australian dollar.

Overall, while a very vanilla approach to QE could work in Australia there are risks to financial stability as the starting point is very different to other countries' experience. The equity market is higher, as are valuations, bond yields are already at record lows and the household sector is highly levered.

Investment implications

The spread of the COVID-19 virus was not something that investors or policy makers had factored into their outlook a few short months ago. The transitory nature of the economic impact from the virus is being tested as more countries react to the spread and the risks a global recession rise.

For Australia, it comes at a time when the domestic economy was already experiencing a period of weakness, and is exacerbated by the reliance on the international sector for trade, tourism and education.

A record low on the cash rate and another step closer to the lower bound raises the chance of the RBA enacting QE. However, unconventional policies are no panacea to persistently low inflation or a mediocre economic backdrop. Then there are the concerns surrounding the destabilising nature that low rates can have and rising asset prices, notable in the housing market. While these considerations may weigh on the RBA's decision to enter into QE and shape the final package, it doesn't necessarily mean those steps won't be taken.

QE or no QE interest rates and bond yields in Australia are likely to remain at low levels for an extended period of time. Bonds provide a stabilising role in portfolio, a message reinforced by market performance over the end of February, but offer very little in way of income. Higher quality credit has some yield pick up and there are selective opportunities in emerging market bonds for higher coupons. Income seekers with the appropriate time horizon should also consider the role that real assets can play in a portfolio as another source of high quality income.

The Market Insights program provides comprehensive data and commentary on global markets without reference to products. Designed as a tool to help clients understand the markets and support investment decision-making, the program explores the implications of current economic data and changing market conditions.

For the purposes of MiFID II, the JPM Market Insights and Portfolio Insights programs are marketing communications and are not in scope for any MiFID II / MiFIR requirements specifically related to investment research. Furthermore, the J.P. Morgan Asset Management Market Insights and Portfolio Insights programs, as non-independent research, have not been prepared in accordance with legal requirements designed to promote the independence of investment research, nor are they subject to any prohibition on dealing ahead of the dissemination of investment research.

This document is a general communication being provided for informational purposes only. It is educational in nature and not designed to be taken as advice or a recommendation for any specific investment product, strategy, plan feature or other purpose in any jurisdiction, nor is it a commitment from J.P. Morgan Asset Management or any of its subsidiaries to participate in any of the transactions mentioned herein. Any examples used are generic, hypothetical and for illustration purposes only. This material does not contain sufficient information to support an investment decision and it should not be relied upon by you in evaluating the merits of investing in any securities or products. In addition, users should make an independent assessment of the legal, regulatory, tax, credit, and accounting implications and determine, together with their own professional advisers, if any investment mentioned herein is believed to be suitable to their personal goals. Investors should ensure that they obtain all available relevant information before making any investment. Any forecasts, figures, opinions or investment techniques and strategies set out are for information purposes only, based on certain assumptions and current market conditions and are subject to change without prior notice. All information presented herein is considered to be accurate at the time of production, but no warranty of accuracy is given and no liability in respect of any error or omission is accepted. It should be noted that investment involves risks, the value of investments and the income from them may fluctuate in accordance with market conditions and taxation agreements and investors may not get back the full amount invested. Both past performance and yields are not reliable indicators of current and future results.

J.P. Morgan Asset Management is the brand for the asset management business of JPMorgan Chase & Co. and its affiliates worldwide.

To the extent permitted by applicable law, we may record telephone calls and monitor electronic communications to comply with our legal and regulatory obligations and internal policies. Personal data will be collected, stored and processed by J.P. Morgan Asset Management in accordance with our privacy policies at <https://am.jpmorgan.com/global/privacy>.

This communication is issued by the following entities: in the United Kingdom by JPMorgan Asset Management (UK) Limited, which is authorized and regulated by the Financial Conduct Authority; in other European jurisdictions by JPMorgan Asset Management (Europe) S.à r.l.; in Hong Kong by JPMorgan Asset Management (Asia Pacific) Limited, or JPMorgan Funds (Asia) Limited, or JPMorgan Asset Management Real Assets (Asia) Limited; in Singapore by JPMorgan Asset Management (Singapore) Limited (Co. Reg. No. 197601586K), this advertisement or publication has not been reviewed by the Monetary Authority of Singapore; in Taiwan by JPMorgan Asset Management (Taiwan) Limited; in Japan by JPMorgan Asset Management (Japan) Limited which is a member of the Investment Trusts Association, Japan, the Japan Investment Advisers Association, Type II Financial Instruments Firms Association and the Japan Securities Dealers Association and is regulated by the Financial Services Agency (registration number "Kanto Local Finance Bureau (Financial Instruments Firm) No. 330"); in Australia to wholesale clients only as defined in section 761A and 761G of the Corporations Act 2001 (Cth) by JPMorgan Asset Management (Australia) Limited (ABN 55143832080) (AFSL 376919); in Brazil by Banco J.P. Morgan S.A.; in Canada for institutional clients' use only by JPMorgan Asset Management (Canada) Inc., and in the United States by J.P. Morgan Institutional Investments, Inc., member of FINRA; J.P. Morgan Investment Management, Inc. or J.P. Morgan Alternative Asset Management, Inc.

In APAC, distribution is for Hong Kong, Taiwan, Japan and Singapore. For all other markets in APAC, to intended recipients only.

Copyright 2020 JPMorgan Chase & Co. All rights reserved.

Material ID: 0903c02a8282d95f