Informational commentary from Pacific Asset Management LLC, investment manager for certain U.S. fixed income options within Pacific Life variable annuities.

COVID-19 UPDATE: FLATTENING THE CURVE

At its core, this is a health crisis feeding an economic crisis and leading to a developing liquidity crisis

Dominic Nolan, senior managing director of Pacific Asset Management LLC, provides his analysis below of the markets currently battered by the COVID-19 pandemic. In this fluid economic environment, it's important to note that these are his views as of March 15, 2020.

On March 13, President Trump declared a national emergency under the Stafford Act. He also initiated a public-private partnership with major U.S. companies to begin broad testing for COVID-19. Markets rallied almost 10% heading into the weekend. Sunday, March 15, the Federal Reserve (Fed) made an emergency rate cut, reducing the target rate range to 0%-0.25% and announcing an intent to purchase at least $700 billion in U.S. Treasury and mortgage-backed securities. The first fiscal stimulus from Congress is expected via the Families First Coronavirus Response Act, and other governments are ramping up efforts to combat the COVID-19 pandemic. Despite these efforts, equity futures were "limit down," on March 15, suggesting the stock market will suffer through another painful day. Investors are bracing for a volatile week.

National Emergency

President Trump's national emergency declaration allows access to over $40 billion in FEMA funds. These funds can be used to bolster our healthcare system's ability to handle the expected dramatic rise in cases. The U.S. would most likely be short on health-care professionals, beds, and ventilators for starters. The state of national emergency also allows for more flexibility within government agencies, hospitals, and doctors to treat the outbreak. During one of the recent presidential press conferences, executives from various U.S. corporations spoke in support of what will be a large public-private partnership to speed up broad testing. This is a good thing.

Federal Reserve

On March 15, the Fed, moving ahead of its scheduled March 17-18 meeting, did an emergency rate cut of 100 basis points, lowering the target rate to a range of 0%-0.25%. In addition, the Fed announced plans to purchase at least $700 billion in government securities. Chair Jerome Powell stated the Fed is prepared to do more as liquidity and economic concerns prompted such action.

Fiscal Stimulus

Early in the morning on March 14, the House of Representatives passed a bipartisan bill named the Families First Coronavirus Response Act. It is expected to be approved by the Senate on March 16 and signed by the President shortly thereafter. At a high level, it is a fiscal stimulus start, allowing for free testing and paid sick leave. More importantly, it shows that Washington D.C. is beginning to understand the urgency needed to help the economy weather this storm. I would expect more powerful fiscal stimulus to be passed over the next few weeks.

Other Countries

Germany also fired a round recently as Chancellor Angela Merkel stated her country would do "whatever it takes" to fight the Coronavirus. The Chancellor was supportive of increased spending on health measures, providing liquidity for companies, and giving furlough pay for workers. This was a very uncharacteristic move for a budget-conscious country. Additionally, the Bank of Japan, following the Fed's lead, moved its policy meeting up to March 16. It is widely expected the Bank of Japan will cut rates and increase asset purchases.

Flattening the Curve

At its core, this is a health crisis that is feeding an economic crisis and leading to a developing liquidity crisis. In my opinion, the Fed acted as it needed to. Remember, these monetary actions are meant to help contain an emerging liquidity crisis. While helpful, I view it as subordinated to the health and economic crisis at this stage, which is why markets are moving through this. However, things would be worse without Fed action.

Unfortunately, the health crisis simply needs time—time to assess and work through the contagion, time to develop therapeutics, time to work on a vaccine, and time so our health system is not overrun. Lessons are being learned from other countries, as South Korea, Singapore, and China seem to be flattening the epidemic curve, while Italy and Iran are being overrun by it. Broad and decisive action is needed, as each country can tolerate a different curve, but once breached, mortality rates increase, and many lives are unnecessarily lost.

The economic crisis is also very fluid. We all know the short-term will be brutal, but if our country is able to flatten the curve over the next six-to-eight weeks, perhaps this will not extend longer than needed. If, however, we are overrun, further dampening the economy, companies will deteriorate quicker, leading to layoffs, which fuel a deeper recession or something worse. Therefore, fiscal firepower will be important, in part to soften the economic impact to most Americans, a majority of whom live paycheck to paycheck, and to provide corporations financial flexibility, helping to slow layoffs.

As for liquidity, the Fed fired a bazooka round March 15 and will probably, along with the Treasury, need to fire one or two more. Fortunately, Chair Jerome Powell stated the Fed is ready to use its "full range of tools to support the flow of credit to households and business." The downside here is the Dodd-Frank Act of 2010 reduces the Fed's emergency response power via limitations on the ability to purchase certain types of assets. A big variable, in my opinion, is the retail investor. In much the same way we have seen a panic in grocery stores, we may see a panic with investments, which results in exacerbating the negative feedback loop. As I write this on March 15, equity futures are "limit down," suggesting another painful day ahead for the stock market.

Definitions

One **basis point** is equal to 0.01%.

The **Dodd-Frank Act (Dodd-Frank Wall Street Reform and Consumer Protection Act)** is a U.S. federal law that places regulation of the financial industry in the hands of the government promoting accountability and transparency in the financial system to protect taxpayers by ending bailouts and protecting consumers from abusive financial services practices.
