The Impact of Covid-19

How will US Politics, Banks and Financial Markets Shape the Future of the Global Economy?

Carol Alexander

Professor of Finance, University of Sussex
Visiting Professor, Peking University HSBC Business School, UK

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Outline

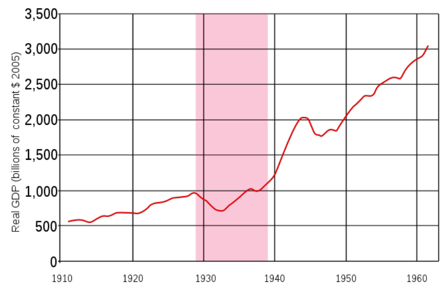
- Central banks have responded to Covid-19 with unprecedented interventions in financial markets which, effectively, amount to printing cash to buy company stocks and bonds, household debt and even their own government securities
- Under Donald Trump, the strategic aim of the US seems to be to increase prices of US assets and decrease the values of ‘safe-havens’ – specifically, the US dollar, gold and silver, and bitcoin and other cryptocurrencies
- Similar tactics were used during the Great Depression of the 1930s – i.e. currency and gold price manipulation, with a sustained economic stimulus
- And since the Banking Crisis of 2008, the same tools have been deployed continuously, to mask the true weakness of the US economy
- What can we learn from the way that government’s handled the two previous crises? How will banks and financial markets respond to the packages employed today?

Part I: The Great Depression

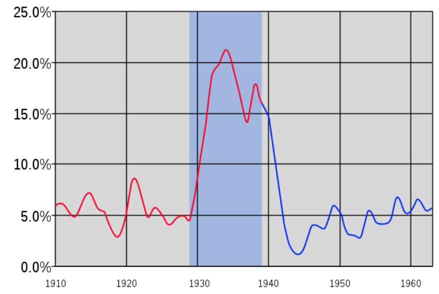
- How did the US economy fare after the 1929 stock market crash?
- What role did banks play?
- How were financial markets used to implement economic policy?
- How did the US economy recover?

US Economy in the 1930s

US GDP



US Unemployment Rate



After the stock market crash of 1929, high unemployment in the US → deflation

→ The US government aimed to increase exports via US dollar devaluation

→ To fund infrastructure and boost manufacturing, also increased money supply

1934 Gold and Silver Acts

Changing gold and silver from currencies to commodities

1934 Gold Reserve Act


POSTMASTER: PLEASE POST IN A CONSPICUOUS PLACE.—JAMES A. FARLEY, Postmaster General

UNDER EXECUTIVE ORDER OF THE PRESIDENT

Issued April 5, 1933

all persons are required to deliver

ON OR BEFORE MAY 1, 1933

all GOLD COIN, GOLD BULLION, AND GOLD CERTIFICATES now owned by them to a Federal Reserve Bank, branch or agency, or to any member bank of the Federal Reserve System.

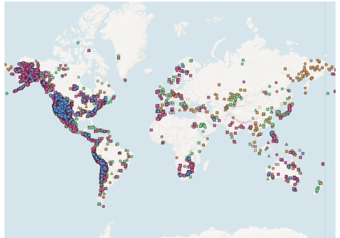
Executive Order

Confiscated @ 1 oz. = \$20.67

Revalued @ 1 oz. gold = \$35

Result 1: US dollar ↓

1934 Silver Purchase Act



50% seigniorage → silver certificates

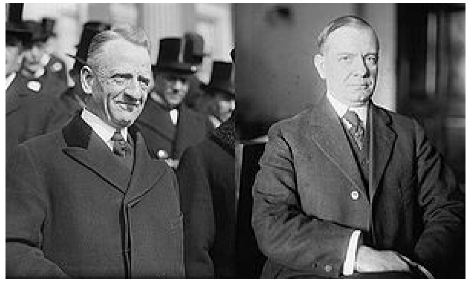
Result 2: ↑ silver price

Result 3: ↑ money supply

Role of Commercial Banks

Commercial banks contributed to the 1920s stock market bubble by finding a loophole in banking laws, setting up subsidiaries, now called investment trusts, to trade in stock markets

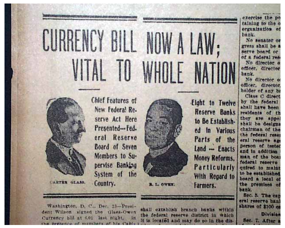
1932: Glass-Steagall Act



Clear distinction between activities of commercial and investment banks

Role of Central Bank

Extension of 1913 Federal Reserve Act → 1933 Emergency Banking Act

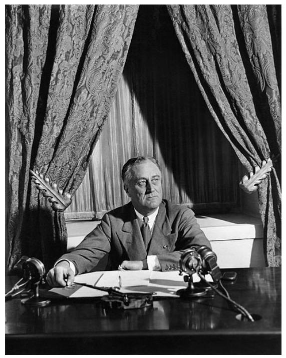

CURRENCY BILL NOW A LAW; VITAL TO WHOLE NATION

Federal Open Markets Committee (FOMC)

- Federal Reserve Bank Presidents + Board Members
- Controls interest rates and the money supply, issuing and trading treasury securities in open market operations with primary dealers

Role of Social Media

Franklin D. Roosevelt (1933 – 1945) Fireside Chats



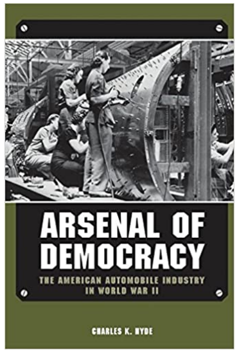

Text of Roosevelt's Fireside Chat Explaining New Recovery Program

1937: Second Downturn in the Economy

1938: Accounting Reforms → Ban on Market-to-Market (MtM)

Recovery from Great Depression

With the outbreak of WW2 car manufacturing almost ceased
→ changed to manufacture military equipment



- 2,600,000 trucks
- 600,000 jeeps
- 50,000 tanks
- 300,000 war planes
- Millions of guns and bombs

Unemployment ↓ Industrial Production ↑ 15% p.a.
Gross National Product ↑ from \$88.6bn in 1939 to \$135bn in 1944

Bretton Woods

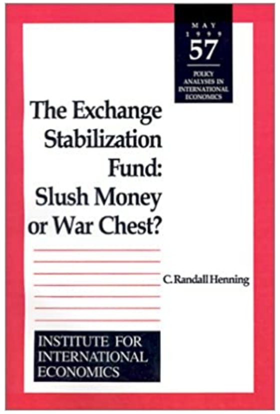
All 44 Allied countries met in 1944 to stabilize exchange rates

- US agreed to adhere to gold standard: 1oz. gold = \$35
- Allies agreed to peg their exchange rates to USD within 1%
- International Monetary Fund (IMF) established with Special Drawing Rights to help maintain parity with US dollar

  2020 XDR = USD 41.73%, EUR 30.93%, CNY 10.92%, YEN 8.33%, GBP 8.09%

Exchange Stabilization Fund

- Established in 1934 as response to UK's Exchange Equalisation Account using \$2bn profits made from confiscated gold
- Originally used to intervene in foreign exchange markets to stabilize the value of US dollar vs. gold
- Bretton Woods Agreement gave permanent authority to the ESF to finance short-term loans to Latin America and other countries in financial crisis
- By October 2009, ESF held assets worth \$105 billion, including \$58.1 billion in special drawing rights (XDR) from the IMF



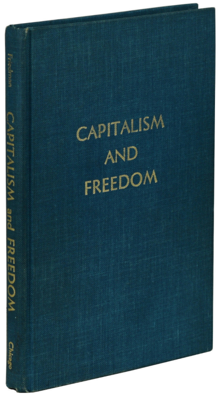
Part II: The 2008 Banking Crisis

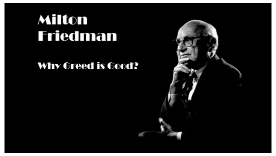
- What drove the post-WW2 US stock market boom?
- How did changes in US banking laws re-shape financial markets?
- What caused the banking crisis of 2008?
- Why are prices of US stocks and bonds still increasing today?

US Economy in the 1950's and 1960's

The Birth of Monetarism

Efficient market economics rather than stabilising exchange rates





- Milton Friedman → restricting money supply to control inflation
- Greed-is-Good philosophy → middle classes replaced commercial banks role in stock price booms

Stock Price Boom ≠ Re-Investment of Profits

- By 1965, 60% of company stock was owned by the middle classes
- But only 6% of profits were re-invested in the company
- 45% went to shareholders and the rest went to highly-paid executives

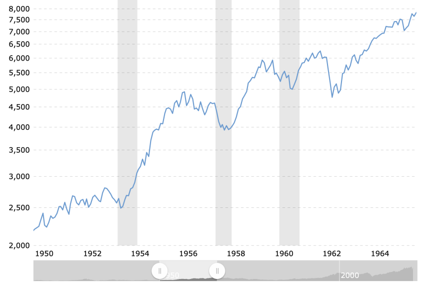
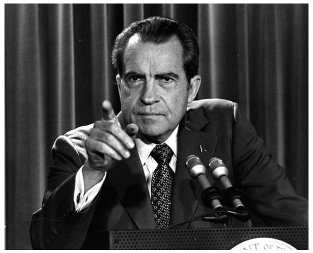


Figure 4: S&P500 returns for individual decades since 1940
Source: Bloomberg, Guinness Atkinson Asset Management

	Total return	Price appreciation	Dividends	Dividends as % of total return
1940s	143.1%	34.8%	108.3%	75.7%
1950s	467.4%	256.7%	210.7%	45.1%
1960s	109.5%	53.7%	55.8%	51.0%
1970s	76.9%	17.2%	59.7%	77.6%
1980s	389.2%	227.4%	161.8%	41.6%
1990s	432.2%	315.7%	107.5%	25.4%
2000s	-9.1%	-24.1%	15.0%	*Not meaningful*
Average	*228.6%*	*125.9%*	*102.7%*	*52.7%*

Nixon, Clinton and Bush



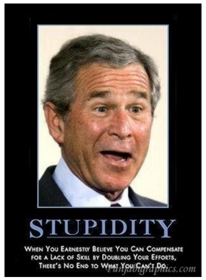
Nixon (1969 – 1974)

1970: Allows ESF to deal in stocks and bonds

1971: Drops the Gold Standard

Clinton (1993 – 2001)

1999: Repeals the Glass-Steagall Act



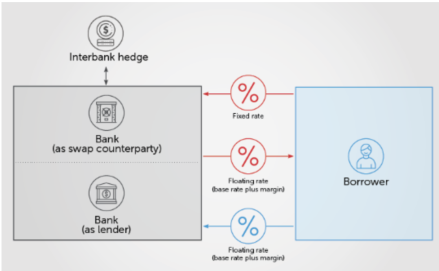
G.W. Bush (2001 - 2009)

2007: Reinstates MtM Accounting

Interest Rate Swaps (IRS)

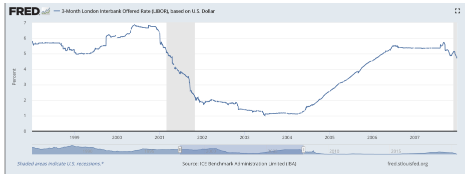
Different accounting practices drive demand for IRS

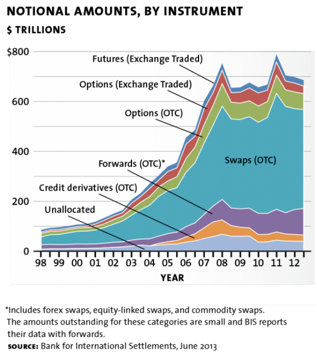
- Cash Accounting → Companies prefer to have fixed rate loans
- MtM Accounting → Banks prefer to give floating rate loans
- Around $400tr notional outstanding in IRS



Interbank hedging of IRS requires liquid bond markets

Monetary Policy of Central Banks





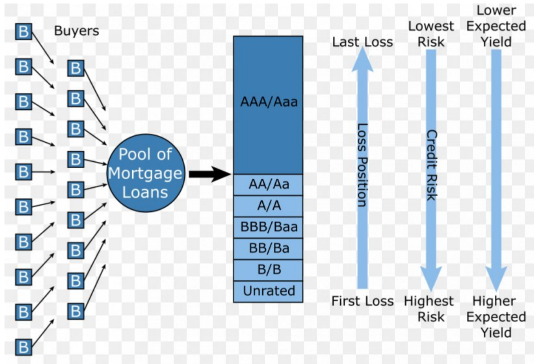
- Following recession of 2001-2 Alan Greenspan kept interest rates too low for too long
- Notional traded on financial derivatives soared as all banks searched for yield

By 2008 derivatives trading exceeded 10 × world GDP by notional amount

Role of Investment Banks

Securitisation of sub-prime debt

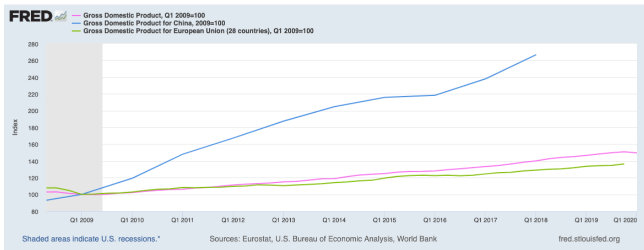
- Commercial banks buy mortgage backed securities (MBS) underwritten by investment banks
- Investment banks further underwrite collateralised debt obligations (CDO)
- Investment banks also sell default insurance for MBS and CDO via credit default swaps (CDS)



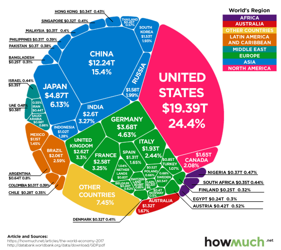
2008: Banks and Financial Markets Collapse

- Rating agencies colluded with investment banks → tranches retain good credit ratings
- Toxic financial bomb → 2011 European sovereign debt crisis
- Federal Deposit Insurance Corporation (FDIC) closed 465 US banks from 2008 to 2012
- Unlike bank accounts money market funds (MMF) are not FDIC-insured
- Investors withdrew more than $250bn from this vital source of liquidity for US corporations – $3.535 ⇊ $3.288 trillion in 10 days
- US Treasury used $23bn in ESF to prop up values of shares in MMFs

Fast Forward from 2009 to 2019



2019 GDP: US ∼ \$22tr, EU ∼ \$18tr, China ∼ \$15tr



Quantitative Easing

2009 – 2017: Three Rounds of QE

- Fed buys securities including its own treasuries but also MBS etc.
- ↑ money supply, ↑ balance sheet

2017: Unwinding of US Federal Debt

- Deflation balance sheet ⇒ No more QE

  ⇒ Money market squeezes and US stock prices ↓

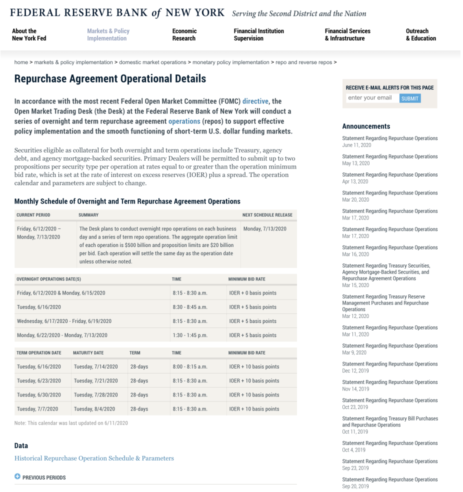
2019: QE4 Repurchase Operations (Repo)

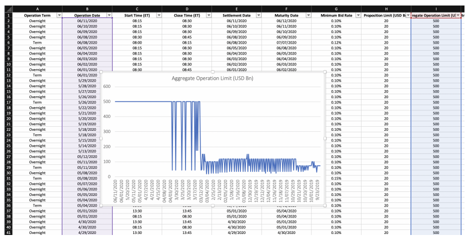
- September 2019 → first interest rate cuts since 2008
- $60bn T-Bills purchased per month in overnight repos by Fed

Part III: Central Banks' Response to Covid-19

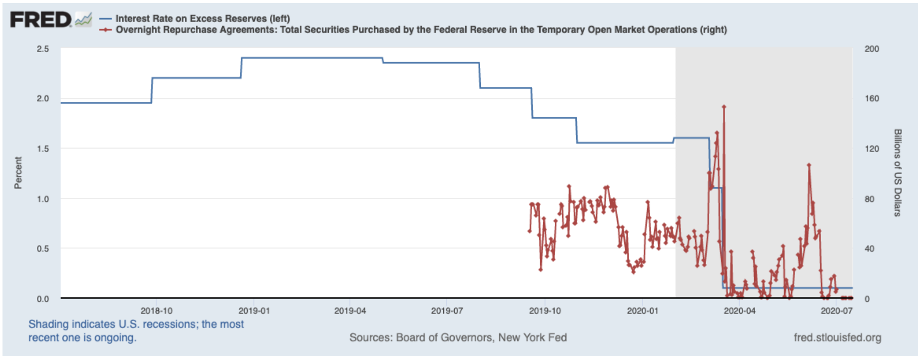
- New tools for extreme monetarist policies
- The Federal Reserve's last resorts?
- Who are the winners and losers
- Financial market dislocation
- Are prices of 'safe-haven' assets being manipulated?
- Global economic outlook

Repo : New Monetary Policy Tool

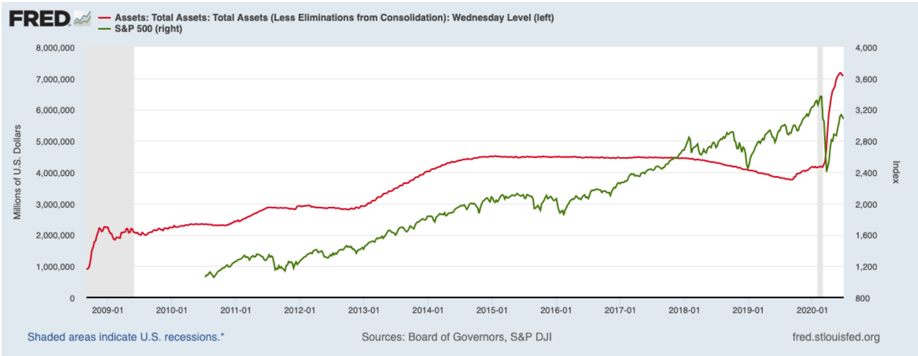




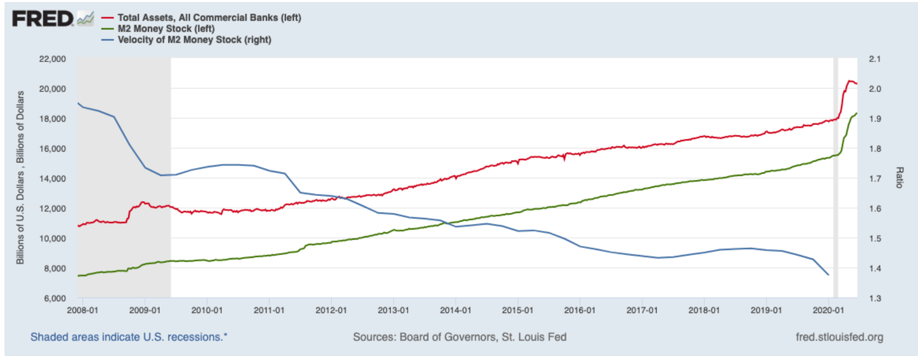
Interest on Excess Reserves (IOER) & O/N Direct Repo



Balance Sheet Expansion \$1tr ↑ \$7tr



Money Supply



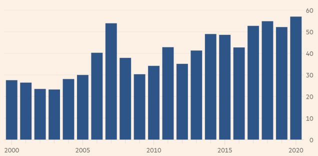
Hedge Fund and Investment Bank Profits

Single-Manager Hedge Funds

	May-20	Apr-20	2020 YTD	12 Months
Hedge Funds	**2.89**	**5.67**	**-2.95**	**1.80**
HF - Event Driven Strategies	3.72	5.91	-7.54	-4.58
HF - Equity Strategies	3.63	7.37	-5.11	1.73
HF - Credit Strategies	1.74	1.96	-5.66	-3.01
HF - Relative Value Strategies	1.70	2.35	0.38	3.23
HF - Macro Strategies	1.59	2.99	-0.03	5.68
HF - Multi-Strategy	1.43	5.21	-2.59	2.71
Activist	3.85	7.62	-7.80	-1.32
Discretionary	3.19	6.32	-4.37	1.32
Volatility	1.87	4.12	-1.01	4.18
Systematic	1.47	3.91	-0.02	1.85
HF - North America	4.36	7.22	-1.41	4.14
HF - Emerging Markets	2.73	5.30	-6.60	-0.30
HF - Developed Markets	2.51	4.24	-3.41	2.28
HF - Asia-Pacific	2.32	5.55	-4.46	0.92
HF - Europe	1.34	3.83	-4.86	-1.48
HF - BRL	3.22	5.14	-6.11	3.61
HF - USD	3.08	5.95	-2.46	2.14
HF - GBP	2.95	3.99	-3.81	0.71
HF - EUR	1.86	3.54	-3.42	-1.45
HF - JPY	-0.26	1.97	-6.97	-4.11
HF - Large ($1bn plus)	3.19	5.01	-1.48	4.48
HF - Emerging (Less than $100mn)	2.85	5.88	-3.88	0.53
HF - Medium ($500-999mn)	2.66	4.62	-4.94	0.02
HF - Small ($100-499mn)	2.55	4.38	-4.18	1.76

Investment banking fees hit a record in the first half of 2020

Year-to-date global investment banking fees ($bn)



All figures year to date
Source: Refinitiv
© FT

Total investment banking fees are up 9 per cent from the first half of 2019, according to Refinitiv. That includes a 30 per cent jump in revenues from underwriting bonds and a 37 per cent rise in fees tied to stock sales.

INVESTMENT BANKING

Deutsche Bank first quarter investment bank profit beats all of 2019

Profits in the division were €622m, nearly 150% up on the same period last year and more than the €445m it made in the whole of 2019

By Paul Clarke
April 29, 2020 8:35 am GMT

Deutsche Bank's shrunken investment bank generated more profit in the first quarter of 2020 than it did in all of last year as the German lender benefited from a huge upswing in bond issuance and increased trading revenues because of the Covid-19 crisis.

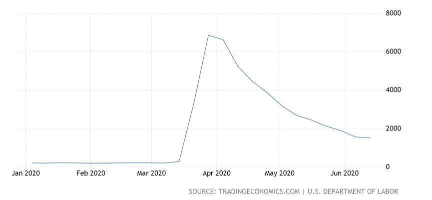
US Household Economics

Covid Aid Relief and Economic Security (CARES) Act of 27 March 2020

Today there is \$14.3tr of household debt. Consumer loans have been massively securitised by banks and P2P lenders

Four US government stimulus packages (so far) pledge about \$3tr to help small business and consumers, aims to prevent wave of defaults triggering another credit crisis

50 million new jobless claims in the US since March 2020



Real unemployment rate 24% or more

Credit Crisis Looms

Term Asset-Backed Securities Loan Facility

- Federal Reserve banks and Blackrock are buying $300bn of securities backed by MBS, car loans, credit card debt, student loans, etc.
- They are also buying new corporate debt in exchange for credit lines up to four years, for all investment-grade companies (e.g. GM alone has a credit line of $2bn)
- Also buying corporate debt in the secondary market – around $2.5bn of large corporate bonds (AT&T, Berkshire Hathaway Energy, McDonalds, etc) and corporate bond exchange-traded funds

ESF Bailout for Money Market Funds

CARES Act allows $500bn from ESF for general "bailouts"

- MMFs are high-quality short-term assets – like bank deposits but not FDIC guaranteed
- Sector provides $4.8tr of liquidity, but with zero or negative interest rates MMFs again threatened by investor withdrawal

- MMF managers have started to bail out prime funds

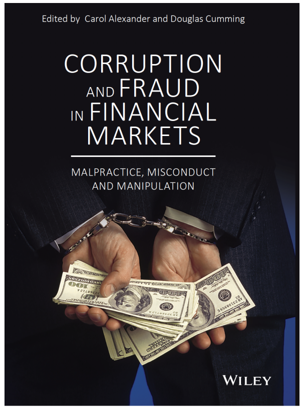
Fed's Last Resorts to "Stabilise" Financial Markets

1. Acting as a lender of last resort to investment funds
   The ESF is used to guarantee value of MMFs
2. Acting as a lender of last resort to securities firms
   Primary Dealer Credit Facility gives funds direct to banks $\leftrightarrow$ Fed
3. Acting as a securities dealer of last resort
   The Fed now intermediates on both sides of the repo market
4. Acting as a securities underwriter of last resort
   For investment-grade corporate bonds or loans to 4 -year maturity
5. Acting as a securities buyer of last resort
   Buying US corporate bonds and ETFs on the secondary market.

QE Goes Global $\rightarrow$ Markets Dislocate

US dollar defends returns on US stocks and bonds

No Safe Haven



ECB Pandemic Emergency Purchase Programme


Banks rush to borrow record €1.3tn at negative rates from ECB

Central bank offers ultra-cheap loans to prevent pandemic becoming credit crunch

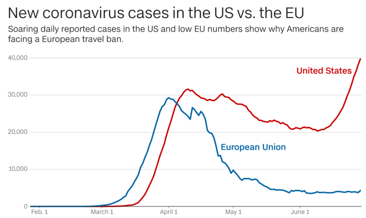
By offering multiyear loans to banks at an interest rate below its main deposit rate, the ECB is effectively providing a subsidy for the banking system © REUTERS

- Negative interest up to -1%
- €765bn ($\sim 60\%$) for banks to repay maturing ECB loans
- €543bn ($\sim 40\%$) to buy new government bonds → red bonds
- Highly profitable carry trade

Coronabonds

- Backed by all member states → low interest → blue bonds
- Joint responsibility → no incentive to reduce debt
- Suggest imposing country-specific limits to blue bond financing and financing the remaining debt using red bonds

Global Economic Outlook



- ↑↑ Debt → 2 or 3 times GDP
- ↑↑ Unemployment → deflation
- ↑↑ Export pressures → negative interest rates and trade tariff wars
- ↑↑ ESF resources → competitive currency devaluations
- ↑↑ Nationalisation of capital markets → yield curve controls