HollisWealth®

MACROSCOPE the market bulletin from Luft Financial

No.37 **18-Jun-2020**

The effect of the "Powell Put" and "Moral Hazard" on your portfolio

The U.S. Federal Reserve (the "Fed"), the most influential and powerful central bank in the world, was instrumental in helping the equity market find a floor on March 23. The Fed's actions announced on that date contributed to the about-turn in investor sentiment that enabled markets to stage a historic rebound in ensuing weeks. However, the jury is still out on the long-term implications of the so-called "Powell Put."

On March 23, the Federal Reserve, in affirming its commitment to "use its full range of tools to support the U.S. economy in this challenging time," announced a number of measures and emergency lending programs to limit the damage inflicted by the pandemic on the economy. While the initial reaction to that announcement was not promising – U.S. indices fell by 3% on March 23 – they recovered strongly in the next couple of days, with the Dow Jones and S&P 500 posting their best two-day performances since 1987 and November 2008 respectively. The TSX soared 12% on March 24, its biggest one-day gain since 1977.

This, then, was the Fed's "whatever it takes" moment, echoing the famous pledge made by former European Central Bank (ECB) governor Mario Draghi at the height of the continent's sovereign debt crisis in 2012, when he used similar words to signal his support for the embattled euro. Just as Draghi's show of support was sufficient to turn the tide for the euro, the Fed's promise of a backstop was enough to inject optimism into the markets and enable companies to issue bonds for raising much-needed cash.

The urgency in the Fed's actions can be attributed to the extreme panic in the financial markets in the middle of March, as the effects of the coronavirus were beginning to be felt all across the global economy. Even as equity markets were plunging, there were tangible concerns of another credit crisis like the 2008-09 one in the fixed income market, leading to a sharp sell-off in bonds and a resultant spike in bond yields.

The credit environment has improved dramatically since then. With the yield on investment grade companies now near record lows (Figure 1), debt issuance by such companies topped a record $1 trillion in May. Even junk bonds are flying off the shelves, as companies hit hardest by the pandemic – like airlines and cruise ship operators – take advantage of robust investor appetite to boost their cash reserves. As we had noted in last week's "Macroscope", speculators have also been snapping up shares of bankrupt companies such as car-rental operator Hertz.

Rightly or wrongly, the "Powell Put" – which refers to the point below which Fed chairman Jerome Powell will not let the market fall before stepping in with stimulus – is probably to blame for these speculative excesses. In that context, a 34% plunge in just over a month, as occurred in March, certainly qualifies as grounds for a "Powell Put."

This tacit market support by the Fed has boosted investors' portfolios and enabled them to claw back most of the losses caused by the market meltdown. A downside to such Fed support is that it extends an unnecessary lifeline to thousands of "zombie" companies that may needlessly soak up hundreds of billions of dollars before they finally go bankrupt, saddling investors and financial institutions with colossal losses.

Such support also raises the risk of "moral hazard", which occurs when an entity has an incentive to increase its risk exposure because it does not bear the full costs of that risk, according to the Wikipedia definition. This was the topic *du jour* during the 2008-09 financial crisis, when policymakers were concerned that bailing out banks and financial institutions would reward them for taking hugely risky, leveraged bets on the U.S. housing market. In the current environment, with the Fed now buying bond ETFs and even individual corporate bonds, there is a distinct possibility that moral hazard will manifest itself in the months ahead.

While the Powell Put has helped your portfolio recover almost to levels that prevailed before the pandemic struck, its downside is the emerging risk of moral hazard.

Figure 1: Investment grade companies can borrow at near record-low costs

Source: Bloomberg Barclays

Quote of the Week

"When your house is burning, the water bill to put out the fire is the least of your worries."
– Author Unknown