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Market View – COVID-19: Policy call and response

By Warren Lovely / Taylor Schleich

We're less than 20 trading days removed from an equity market peak, but in the intervening period, coronavirus (COVID-19) paranoia has spiked and confidence has collapsed, dragging equities into bear market territory and pushing bond yields to extremes. Financial markets have issued a clear S-O-S, and policy makers are reacting. A global stimulus effort is being marshaled in an effort to limit virus fallout. It's a call and response exercise being played out globally and one that's coming together pretty quickly, all things being equal. Actions (too many to fully list here) include aggressive rate cuts by central banks and a growing array of fiscal policy measures. Canada is in on the act. The BoC cut 50 basis points on March 4th and will do more soon (imminently?). Federal-provincial governments will be rushing out fiscal measures, or in some cases, backing away from planned restraint. Compare Canada's COVID-19 policy response to three prior events: the SARS outbreak of 2002-04, the Global Financial Crisis of 2007-09, and the oil price collapse of 2004-16.

<table>
<tr><th colspan="2">SARS Outbreak (2002-04)</th></tr>
<tr><td colspan="2">Context: First case reported in China Nov-02; spread to Canada Feb-03; by Apr-2003, WHO (briefly) advised against non-essential travel to Toronto; total SARS cases ultimately topped 8k globally, with 774 deaths officially linked to disease; 43 of those deaths where in Canada, the largest number of fatalities outside of China and HK.
Cdn economy: Hit concentrated in Mar-03 to May-03 | GDP: -0.4% over 2 months (from Feb-03 to Apr-03) | Jobs: -19k/-0.1% over 3 months (from Feb-03 to May-03)
TSX: -9% peak to trough (from Jan-03 to Mar-03) | WTI: -23% peak to trough (from Mar-03 to Jun-03)</td></tr>
<tr><td>Monetary policy response: Modest-Moderate | Somewhat delayed</td><td>Fiscal policy response: Fairly limited | Meaningfully delayed</td></tr>
<tr><td>BoC cut its policy rate, which had been 3.25%, by 25bps in Jul-03, citing a domestic economy "undercut" by SARS and BSE. This initial move came well after the peak in stocks/oil and was also somewhat delayed relative to GDP/jobs hit (which was concentrated in the Spring). Another 25bp cut was delivered Sep-03, as sources of economic weakness broadened from SARS/BSE to Ontario power blackout and forest fires in Western Canada. In response to further adverse economic developments and risks tied to a stronger C$, the BoC delivered three additional cuts (25bps a piece) in 2004, bringing aggregate relief in 2003-04 to 125 bps and leaving the target rate at 2%.</td><td>Liberal majority under Chrétien was spending rapidly prior to SARS outbreak, but still running material budget surpluses. There was no mention of SARS in the Feb-03 budget. As the crisis grew, post-budget measures were announced, including an offer of $250mln in relief for Ontario, which was rejected as inadequate. By Dec-03, Martin had replaced Chrétien and relief to Ontario was enriched to $330mln (~1/3 of estimated health costs). Mar-04 budget identified lessons learned, outlining $665mln of reactionary measures to strengthen the public health system and address readiness gaps. New public health money was part of $8.3bln (over 3 years) in new initiatives, a good portion booked into outgoing fiscal year. Overall, limited change in cyclically adjusted federal budget surplus, which remained near 1% of GDP.</td></tr>
<tr><th colspan="2">Global Financial Crisis (2007-09)</th></tr>
<tr><td colspan="2">Context: Aka Great Recession, banking/financial crisis (rooted in a subprime mortgage bubble) spread across globe, leading to sharply lower levels of economic activity and meaningful job losses; Canada subject to relatively smaller hit and emerged quicker than some, partly due to soundness of banking sector and effective regulation put in place prior to crisis.
Cdn economy: Hit concentrated in Aug-08 to Jun-09 | GDP: -4.7% over 10 months (from Jul-08 to May-09) | Jobs: -427k/-2.5% over 8 months (from Oct-08 to Jun-09)
TSX: -50% peak to trough (from Jun-08 to Mar-09) | WTI: -78% peak to trough (from Jul-08 to Dec-08)</td></tr>
<tr><td>Monetary policy response: Extreme | Reasonably timely</td><td>Fiscal policy response: Extreme | Somewhat timely</td></tr>
<tr><td>BoC started easing in Dec-07, some six months removed from the initial peak in TSX but still at the leading edge of reported economic weakness and well in advance of decline in oil prices. Starting from 4.25%, first cut was 25bps, with statement highlighting U.S. sub-prime mortgage losses, rising bank funding costs and tightening of credit conditions. BoC continued to cut in early 2008. By Apr-08, BoC target rate was down to 3%, where it held until Fall 2008. Thereafter, deepening economic/financial system weakness required a second wave of easing, eventually bringing the target rate to a record low of 0.25% in Apr-09. Total easing amounted to 425bps over 18 months, including one 75bp cut and five 50bp moves—one of which (in Oct-08) was an "emergency"/unscheduled move, coordinated with the Fed, ECB, BoJ and other major central banks. Pursuant to a conditional commitment issued in Apr-09 (which amounted to "exceptional guidance" on the path for the target rate), the BoC waited until Jun-10 before easing the policy rate up to 0.5%, re-establishing "normal functioning" of the overnight market (i.e., 50bp band).</td><td>Harper's Conservative minority had been cutting taxes going into the crisis. Oct-07 eco statement highlighted downside risks while announcing $60bln in broad-based tax relief over 5 years. Feb-08 budget announced further $30bln over 3 years (80% of it tax relief) and modernized BoC authorities preemptively. Fiscal response was boosted as contagion spread. By Nov-08, fed statement acknowledged U.S. recession, giving FinMin extra powers to support the financial system. An auto bailout was delivered Dec-08. Jan-09 budget ("Canada's Economic Action Plan") unleashed large-scale fiscal stimulus to combat crisis. Some $40bln of new measures over 2 years were worth 1.9% of GDP in 2009 (2.5% over 2 years) + anticipated "sector leverage". The focus included PIT relief, enhanced EI, work sharing, skills/training, home reno tax credit & other housing measures, infrastructure spending, business tax measures. Critically, 2009 budget outlined up to $200bln in an Extraordinary Financing Framework, to provide needed financing/liquidity. That included the Insured Mortgage Purchase Program, business credit programs via financial Crowns and extraordinary BoC liquidity measures/standby facilities for banks. Mar-10 budget delivered year 2 of action plan but emphasized fiscal "exit strategy" and need to return to balance.</td></tr>
<tr><th colspan="2">Oil Price Collapse (2014-16)</th></tr>
<tr><td colspan="2">Context: After a few years of strength/stability, oil prices swooned in the second half of 2014, remaining under pressure until early 2016; both supply and demand side factors were to blame; the former (supply side) included rapid growth in U.S. shale oil production, while the latter (demand side) included weaker global growth. Canada's oil patch was particularly hard hit.
Cdn economy: Hit concentrated in Nov-14 to May-15 | GDP: -0.7% over 5 months (from Dec-14 to May-15 | Jobs: -33k/-0.2% over 2 months (from Oct-14 to Dec-14)
TSX: -24% peak to trough (from Sep-14 to Jan-16) | WTI: -76% peak to trough (from Jun-14 to Feb-16)</td></tr>
<tr><td>Monetary policy response: Modest | Somewhat timely</td><td>Fiscal policy response: Moderate | Somewhat-Meaningfully delayed</td></tr>
<tr><td>Starting from the low level of 1% (i.e., with limited conventional room to respond), the BoC cut its target rate 25bps in Jan-15. This first rate cut occurred more than six months after 'peak oil', with WTI contracting >50% before the BoC acted. By this time, the TSX had hit its trough, down nearly 25% on the BoC's Jan-15 decision day. While oil prices largely remained stable in the six months that followed, weak growth in China and the U.S., alongside further deterioration in Canada's resource sector investment outlook led the BoC to drop rates once more, by 25bps in Jul-15. At that time, a gloomy energy sector outlook contrasted with a strong consumer and improving labour markets, as the BoC noted in its rate statement. This second/final cut brought the target for overnight down to 0.5%, where it would remain until mid-2017 (when sufficient economic strength allowed for the first removal of emergency rate cuts).</td><td>Fiscal measures presented by Conservatives in Fall 2014 and Spring 2015 amounted to $10bln (cash basis) or 0.5% of GDP, but Harper ruled out running deficits to boost an economy hit by low oil prices. Trudeau's Liberals defeated the Conservatives in Oct-15, having run on a platform that included temporary fiscal stimulus. The first fiscal update from the Liberals, in Nov-15, noted the economy had contracted in 2015:H1, with oil hurting incomes, profits and business investment. A middle class tax cut and other measures were announced in Dec-15, worth $1.3bln fully implemented. But it wasn't until the Mar-16 budget that the Liberals were really able to deliver significant stimulus. New budget measures were worth $11.6bln for 2016-17. Combined with the Dec-15 tax cut, the estimated boost to GDP was 0.5% in year one (with corresponding jobs impact estimated at +43k). Budget actions included new housing investment, infrastructure money, child/senior benefits, youth employment, EI enhancements, open immigration policy. The prior administration's Balanced Budget Act was repealed to allow for deficits, which continue today.</td></tr>
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*** COVID-19 Outbreak (2019-20) ***	
Context: Chinese authorities began treating pneumonia from an unknown cause in Dec-19; by Jan-20, the province of Hubei was locked down and first cases had been confirmed outside China; virus subsequently spread rapidly in parts of Middle East and Italy; cases now mounting across Europe and in the U.S.; as of this writing, there are 126k cases worldwide and >4,600 deaths; global supply chains and travel/transportation heavily impacted; large events and public gatherings are being cancelled; in some cases, entire countries (i.e., Italy) are effectively quarantined. **Cdn economy:** Hit likely to be concentrated in 2020:Q2, although outlook uncertain | **GDP:** Data only available to Dec-19 | **Jobs:** Data only available to Feb-20, no job losses yet reported **TSX:** -27% peak to current (from 20-Feb-20 to 12-Mar-20 @ 9:45 ET) | **WTI:** -51% peak to current (from 6-Jan-20 to 12-Mar-20 @ 9:45 ET)	
Monetary policy response (announced + *expected*): Strong? | Quite timely	**Fiscal policy response (announced + *expected*): Strong? | Reasonably timely**
Less than 10 sessions removed from an equity market peak and 24 hours after an emergency/inter-meeting FOMC rate cut, the BoC lowered its benchmark interest rate 50bps on 4-Mar-20. At that time, Governing Council indicated a willingness to ease further if downside risks materialized, a message Governor Poloz subsequently reiterated. In light of mounting economic damage and given sharply lower oil prices, we project a further 50bps of easing on *or before* 15-Apr-20. Dramatic oil price weakness and deteriorating financial conditions, if extended, would argue for an unscheduled move. The last time the BoC acted inter-meeting was October 2008, when the Global Financial Crisis raged. Assuming the BoC's policy rate is no higher than 0.5% by mid-year, cumulative monetary policy relief would amount to no less than 125bps in very short order. To the extent Canada's fiscal response (discussed to the right) proves efficacious, the magnitude of rate cuts in Canada could be somewhat less than south of the border (where the target range for fed funds rate is likely to hit the lower effective bound of 0% to 0.25% relatively quickly). Given the highly uncertain backdrop and asymmetric balance of risks, a near-term move by the BoC back to a record low overnight target rate of 0.25% (as was required in Global Financial Crisis) should not be ruled out. Markets are increasingly discounting this type of outcome, which is understandable given the sheer carnage accumulating in equity markets. Circuit breakers have been triggered once more as we write this. The closer we edge the policy rate to zero, the more attention can be expected to shift to prospective unconventional policy measures. The BoC's unconventional policy toolkit includes: explicit forward guidance on interest rates, quantitative easing and other types of asset purchases. As noted in the discussion of the GFC, the BoC has successfully used a conditional commitment in the past, stating in Apr-09 that they intended to hold the record low target rate of 0.25% at that level for one year. As in the U.S., there's likely a preference to avoid negative nominal interest rates in this country. Resolve could well be tested.	Trudeau's Liberals were re-elected in Oct-19—although reduced to a minority—on a platform calling for larger near-term deficits/net new fiscal stimulus. That plan was crafted *prior* to the COVID-19 outbreak and also pre-dated a substantial pension accounting adjustment which adds significantly to Ottawa's deficit ($7.6bln in 2020-21 alone). In Dec-19, Ottawa enhanced the Basic Personal Amount (the threshold above which personal income is taxed) in a move that will ease the tax bill of ~20mln Canadians. That's worth $25bln over 5 years. In other words, federal fiscal policy had pivoted into mildly stimulative territory *before* the coronavirus arrived. On 11-Mar-20, the PM outlined the government's *initial* response to the COVID-19 pandemic, including a $1bln response fund. That covers a range of initiatives, including surveillance, preparedness, acquiring supplies, research, public education, EI supports for quarantined workers, etc. The government will strengthen access to business credit via its financial Crowns, while providing flexibility on tax obligation payments. The price tag attached to these COVID-19 countermeasures may appear underwhelming, but we don't see Ottawa's response to this crisis being defined by or limited to Trudeau's plan of Wednesday. We expect complementary and additional fiscal measures will be unveiled in the upcoming 2020 federal budget (due 30-Mar-20). As recently as last week, Morneau expressed a preference for setting aside a larger reserve, in the event growth really wobbles. But a more adverse economic scenario has rapidly become Canada's new baseline. We've lopped >1%-pt from our 2020 real GDP growth forecast and, as we saw in 2015, dramatically lower oil prices (if sustained) are going to hammer the GDP deflator too. Back of the envelop calculations suggest the rapid slash to 2020 nominal GDP might directly cost Ottawa $10bln, although that GDP hickey will be partially offset by savings attached to rock bottom interest rates. We'd note that Trudeau's post-election mandate letter to FinMin Morneau included, as one of four overriding principles, an instruction to "preserve fiscal firepower in the event we need to respond to an economic downturn". Well, that time has arrived. It's noteworthy that FinMin Morneau has repeatedly emphasized the government's fiscal capacity to respond. That generally boils down to a low net debt-to-GDP ratio—the lowest in the G7, even when controlling for net liabilities at all levels of government. So yes, Ottawa has room to act without destroying the government's long-term fiscal sustainability. The non-partisan Parliamentary Budget Officer's recent *Fiscal Sustainability Report* concluded as much. At the risk of overstating things, the budget may be something of a make-or-break moment for this government and Canada's near-term growth outlook. The stage is yours Mr. Morneau, but a fiscal stimulus package of $20-25 bln/year might be appropriate, equivalent to ~1% of GDP (which again is about the size of the hit the economy looks to be taking this year, relative to the previously assumed run rate). In light of rapidly eroding liquidity, Canada might also need to consider a variant of the Crisis-era extraordinary financing framework in order to bolster the financial system. It's not premature to be thinking about such things. As a de facto shock absorber, the GoC T-bill program could be materially increased to help finance marginal red ink and to compensate for curtailed liquidity in the bond market. Next week's $15bln T-bill tender—the largest since Spring 2017—might just be a warm up act. The size of the T-bill lift will help determine gross GoC bond supply for 2020-21, but more budgetary red ink, sizeable refi needs and other financial requirements could mean a record bond crop for the coming fiscal year. Finally, note that the Liberals will need to steer their budget through a minority House of Commons and a fractured Senate. But as the economic threat level escalates, the case for setting aside partisan differences presumably strengthens. We will see. (Note: Harper's Conservatives were able to secure timely passage of a highly stimulative 2009 budget in a minority Parliament.) Provincially, Québec's fresh budget was notably stimulative, while Alberta is backing away from planned fiscal restraint in light of the recent oil price hit and risks posed to the energy sector.

A few notes on our table: This note deliberately trains the spotlight on Canada. One could obviously take a broader/more international perspective. Moreover, we've limited our discussion of fiscal policy actions to the federal government, but clearly acknowledge that provincial and municipal levels of government have played important roles in mitigating past economic shocks… and will do so again with COVID-19. We've opted for a condensed summary of prior crises/events and the resulting policy responses. Plenty of additional detail can be accessed on past actions/measures, particularly on the fiscal side (where implementation details are often critical). We've loosely assessed the magnitude and timeliness of past monetary and policy responses (highlighted in the page 1 table like this), but these characterizations are admittedly subjective. We're not seeking to disparage or second guess past actions. Monetary and fiscal authorities were surely doing their best with the information they had in hand, limited in some cases by the tools at their disposal and/or other considerations (e.g., the electoral cycle). Finally, as should be obvious, the reaction to the unfolding COVID-19 crisis is evolving and ongoing. Our characterization of the Canadian policy response (highlighted in the page 2 table like this) reflects not merely what has been announced but builds in our expectation of future/additional measures. Much will be communicated in the coming days, weeks and months… from central banks and government leaders all across the globe.

Wrapping up: Have policy makers learned their lesson when it comes to responding quickly to economic speedbumps and financial market dislocations? Perhaps. Is investor tolerance for inaction today virtually non-existent? No question! Either way, central bankers and budget chiefs (in Canada and elsewhere) are rapidly coming to terms with the COVID-19 threat.

We'll see an almost certain and meaningful hit to Q2 growth, and as our colleague Stéfane Marion noted this morning, equity bear markets have tended to be ominous signals when it comes to outright recession. (Looking at bear markets for the S&P 500, seven of the 10 previous episodes were accompanied or followed by recessions: 1957, 1968, 1973, 1980, 1990, 2000 and 2007. Bear markets without recessions were observed in 1961, 1966 and 1987.)

At this point, our expectation of a return to positive growth later this year assumes rapid deployment of stimulus in Canada and abroad. Of course, it really remains to be seen just how effective the policy prescription proves to be, since we've really just got the ball rolling.

Panic is not an endearing quality for policy makers and/or government leaders, but if we were to offer **a few unsolicited words of advice: come hard and come fast with monetary and fiscal stimulus, before consumer and business confidence is truly shattered by COVID-19.** Notwithstanding the growing human toll, financial markets are infected globally, of this, there should be no debate. Now's not the time to underwhelm.

NATIONAL BANK OF CANADA FINANCIAL MARKETS

Economics and Strategy

Montreal Office
514-879-2529

Stéfane Marion
Chief Economist and Strategist
stefane.marion@nbc.ca

Matthieu Arseneau
Deputy Chief Economist
matthieu.arseneau@nbc.ca

Krishen Rangasamy
Senior Economist
krishen.rangasamy@nbc.ca

Paul-André Pinsonnault
Senior Economist
paulandre.pinsonnault@nbc.ca

Marc Pinsonneault
Senior Economist
marc.pinsonneault@nbc.ca

Kyle Dahms
Economist
kyle.dahms@nbc.ca

Jocelyn Paquet
Economist
jocelyn.paquet@nbc.ca

Angelo Katsoras
Geopolitical Analyst
angelo.katsoras@nbc.ca

Toronto Office
416-869-8598

Warren Lovely
Chief Rate Strategist, Economics and Strategy
warren.lovely@nbc.ca

Taylor Schleich
Associate, Rates Strategist, Economics and Strategy
taylor.schleich@nbc.ca

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