EQUITY MARKETS: HAVE POLICYMAKERS CREATED PAVLOVIAN MARKETS?

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Historically, Wall Street has exhibited a propensity to respond positively to counter-cyclical monetary and fiscal policies. This is not surprising. After all, this is what textbook Keynesian economics, combined with rational expectations, is all about: when the private sector spends less, the public sector should borrow to spend more. Rational markets should expect such counter-cyclical behavior to stabilize the economy.

What is more surprising and worth noticing is that Wall Street is responding faster and faster to counter-cyclical policies, as if it was 100% sure that past experience is a sure guide to the future. In the context of the Covid-19 crisis, the response time of the U.S. and global equity markets to the beginning of the implementation of counter-cyclical monetary and fiscal policies has indeed shrunk to zero. Like Pavlov's dogs, who tend to salivate before food is actually delivered to their mouths, markets seem to be acquiring a conditioned reflex whereby mere policy announcements seem to matter more than effective, successful and sustainable implementation. Paradoxically, the credibility of policymaking may have become a new source of vulnerability.

The rebound of equity markets since 23 March has surprised and wrong-footed more than one seasoned investor. It has indeed happened in the midst of data releases indicating the steepest and deepest recession since the Great Depression. Admittedly, equity markets have a well-known propensity to climb a wall of worries and to bottom out some months before the real economy recovers. But this time, the level of uncertainty seems unusually elevated, given the unique nature of the crisis. For example, once bitten, twice shy, the (many) private agents who entered this crisis with low cash balances might now be willing to hold larger cash balances: as suggested by Larry Summers, "just in case" is replacing "just in time". This begs the question of knowing whether the usual monetary and fiscal multipliers apply this time.

Notwithstanding such a potential headwind, markets have wasted no time to embrace a V-shaped scenario: to wit, for the S&P 500 the consensus expects earnings per share (EPS) to have almost fully recovered by Q2 2021 and to resume "normal" growth beyond (Figure 1).

In short, equity markets seem to behave as if there was no downside risk at the present juncture. Undoubtedly, this is testimony to the credibility of monetary and fiscal policymakers who have clearly shown, especially in the U.S, their readiness to do "too much, too early" rather than "too little,

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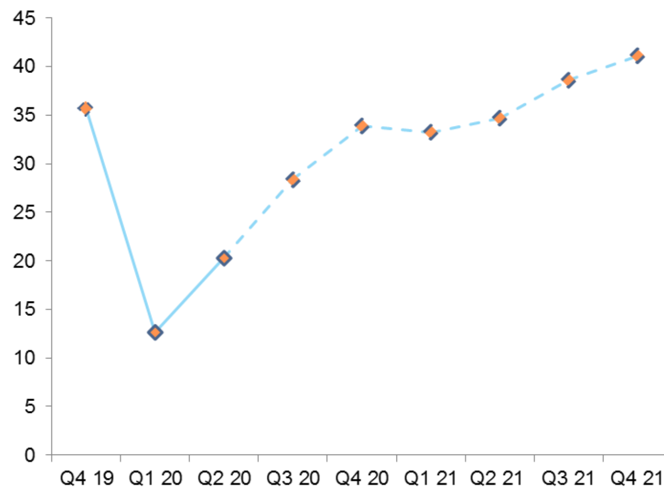
too late". Policymakers in the U.S., the usual first movers, seem to have become so credible in the mind of global markets that they are able to trigger a conditioned Pavlovian global "Buy" response through mere announcements. By taking this posture, policymakers have been giving a master class in expectations management.

Figure 1 – U.S. equity market prices V-shape recovery

S&P 500 EPS, consensus forecast, in USD



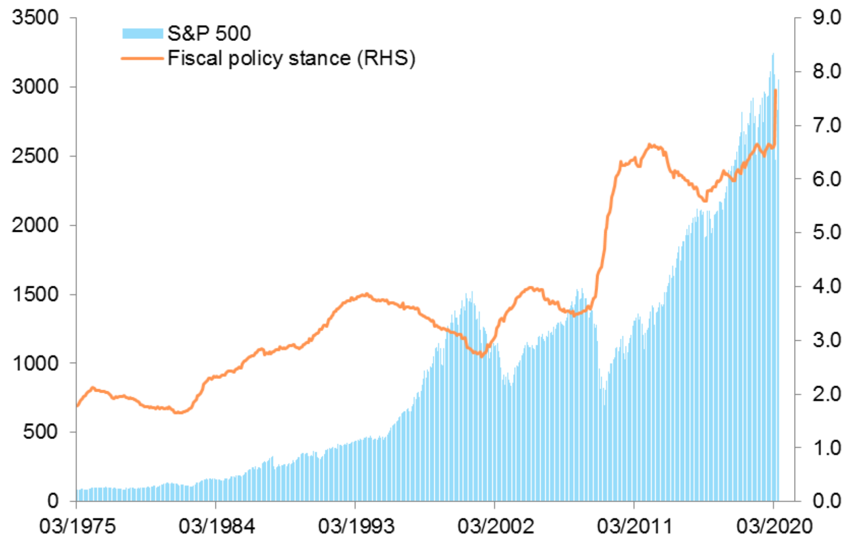
Sources: Refinitiv , Allianz Research

At the same time, it has at least partially dispensed them from putting their money where their mouth is. For example, the Federal Reserve has - for the time being - spent very little money on buying corporate bonds, a new policy presented as a genuine breakthrough when it was announced. Yet, corporate spreads have narrowed since the Fed's announcement.

The same holds true as regards fiscal policy, which – given the truly exogenous nature of the current crisis – has a greater role to play than usual. The stance of fiscal policy is commonly assessed by expressing the budget deficit and public debt as a percentage of GDP. However, since the U.S. Federal Government does not own the U.S. GDP, the ratio of Federal debt-to-tax receipts and the ratio of tax receipts-to-outlays seem thus more appropriate to gauge the stance of fiscal policy (to eliminate the seasonality in federal receipts and outlays, we compute a 12-month moving sum of these monthly times series). The higher these ratios, the more proactive is fiscal policy. In April, the ratio of tax receipts-to-outlays has dropped from 77.4 to 62.8%, while the ratio of Federal debt-to-tax receipts has jumped from 666 to 765% (Figure 2).

This has happened first and foremost because of increased spending, but also because of collapsing tax receipts (respectively +21% and – 3% in the twelve months to April 2020 versus the twelve months to April 2019; +160% and -55% in April 2020 vs April 2019). Surprisingly, since the beginning of March, the Federal Government has not drawn on its large cash balances (USD 1,050 bn as of 04 March); it has, on the contrary, increased it by USD 381 bn.

Figure 2 – S&P 500 versus debt-to-tax receipts ratio (U.S. Federal gov.)



Source: Refinitiv, Allianz Research

Bearing this relative restraint in mind, it is striking to observe that in the current recession, contrary to how things have unfolded in the six previous ones, the S&P 500 has immediately welcomed increased fiscal profligacy. Admittedly, one may ask whether there might be a shortcoming in our way to measure the stance of fiscal policy, because it implicitly considers a decrease in receipts to be equivalent to an increase in overlays. However, from a savings-investment balance point of view, they definitely are equivalent: they both contribute to offset an increase in private savings. And historically receipts have exhibited a more cyclical behavior than overlays: they don't need any kind of new legislation to fall during a recession. Furthermore, this collapse in the response time of Wall Street to counter-cyclical policy is not limited to fiscal policy. It also applies, albeit to a lesser extent, to monetary policy (Table 1 & 2).

Table 1: Response time of S&P 500 to fiscal expansion*

Beginning of recession	Beginning of fiscal expansion		Beginning of S&P 500 rally	Response to fiscal stimulus (in months)		End of recession
	debt-to-receipts	*receipts-to-outlays*		*debt-to-receipts*	*receipts-to-outlays*	
11/1973	11/1974	07/1974	10/1974	-1	5	03/1975
01/1980	10/1979	04/1980	04/1980	6	3	07/1980
07/1981	08/1981	07/1981	08/1982	12	5	11/1982
07/1990	08/1989	07/1990	11/1990	15	9	03/1991
03/2001	05/2001	01/2001	10/2002-03/2003	17-22	17-22	11/2001
12/2007	07/2007	09/2007	03/2009	20	17-22	06/2009
02/2020	04/2020	03/2020	04/2020	0	1	?

Source: Refinitiv, Allianz Research

* The recession dates are those provided by the N.B.E.R.

To date market bottoms, we use a 9-month centered moving minimum of the S&P 500 index. The rally is deemed to start during the month which follows the one when the S&P 500 is at the same level as its 9-month centered moving minimum.

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To date the start of fiscal expansion, we use a 9-month centered moving minimum of the debt-to-tax receipts and receipts-to-outlays ratio and conduct the same test as above.

Table 2: Response time of S&P 500 to monetary easing*

Beginning of recession	Beginning of monetary easing	Beginning of S&P 500 rally	Response to monetary easing (in months)	End of recession
	Fed funds rate cut			
11/1973	07/1974	10/1974	3	03/1975
01/1980	04/1980	04/1980	0	07/1980
07/1981	07/1981	08/1982	13	11/1982
07/1990	07/1990	11/1990	4	03/1991
03/2001	01/2001	10/2002-03/2003	21-26	11/2001
12/2007	09/2007	03/2009	18	06/2009
02/2020	03/2020	04/2020	1	?

Source: Refinitiv, Allianz Research

* The recession dates are those provided by the N.B.E.R.

To date market bottoms, we use a 9-month centered moving minimum of the S&P 500 index. The rally is deemed to start during the month which follows the one when the S&P 500 is at the same level as its 9-month centered moving minimum.

To date the start of monetary easing, we use a 9-month centered moving maximum of the Federal Funds target rate and conduct the same test as above.

In summary, markets have jumped the gun and U.S. policymakers – especially on the fiscal side – are in the position of a poker player who has yet to show his hand and to deliver on his declarations. Among the many factors that could make this exercise difficult are the question of how the burden of this crisis should be shared between capital and labor, as well as the risk of inflating financial bubbles.

These assessments are, as always, subject to the disclaimer provided below.

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