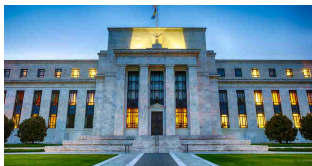


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# Coronavirus Pandemic: Difficult Tradeoffs

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Events surrounding the pandemic continue to evolve fast and furious. Yesterday morning, on March 23<sup>rd</sup>, the Federal Reserve (Fed) announced a range of new actions, dramatic in terms of both initiative and scale. However, the nature of the economic crisis would suggest a lot more will come before this is over.

## The Treasury Market

The Fed was forced to move aggressively. Treasury yields had been rising since March 9 until the 23<sup>rd</sup>, which made no sense in view of the collapse in economic activity taking place. The rise in nominal yields coincided with retreating breakeven inflation rates—10-year Treasury Inflation Protected Securities (TIPS) spiked by about 100 basis points (bps) from their low on March 9, while the dollar surged, and gold tumbled. Some tied the phenomena to an unwind of risk parity trades. Others worried about the scale of debt issuance accompanying the massive fiscal support being organized for the economy. Neither was the real reason.

Forced liquidation in order to raise dollar cash was the most likely cause of the back up in long bond yields. The speed of the deterioration in financial conditions has been outpacing the Fed's response to the crisis. That may have started to change yesterday: the yield on 10-year TIPS is down about 60 bps from last Thursday's peak, breakeven inflation rates are rising, the dollar is off, and gold has rallied. Real yields need to stay down and move lower because market conditions are still not very liquid.

These technical points on the Treasury market are the proverbial tip of the crisis iceberg. Measures taken to address the pandemic are hammering the economy. The longer the measures to contain the spread of the virus remain in place, the greater the prospect of a nightmarish economic scenario. As Larry Kudlow indicated yesterday, the decision on when to pivot away from measures aimed at containing the virus to rebooting the economy will be very difficult, but crucial in every respect.

## Containment and Economic Activity

Economic activity in the U.S. is collapsing. The cause of the contraction are the government-ordered lockdowns and restrictions on public activity aimed at controlling the spread of the virus. The nosedive in activity has been accelerated by warnings from health officials along with fear and anxiety fostered by the daily reporting on the spread of the virus and by announcements of the shutdowns themselves. The virtually shuttered hospitality industry is the most visible example of the economic fallout, but the ripple effects are growing with manufacturing sliding and the auto sector facing industry-wide shutdowns. The services sector, normally a source of stability in a downturn, is leading the way over the cliff. Making matters worse is the cumulative restriction on public sector activity as the frequency of infection builds. More countries and large regions of the developed countries—including several large U.S. states—have announced full-scale lockdowns of everything but essential services.

The severity and speed of the demand shock is enormous. China's economy may have plunged as much as -20% at annual rates in the first quarter. Increasingly, U.S. analysts are calling for similar contractions in annualized growth in the U.S. during 2Q. The stock market is forecasting a recession; past correlations and regional surveys suggest that ISM new orders will fall close to or below the 40% level, and U.S. unemployment insurance claims

could skyrocket from current levels of 280,000 to over 2,000,000. James Bullard, President of the St. Louis Federal Reserve Bank opined last week that the unemployment rate could surge to 30%.

The financial calculus faced by closed business and unemployed households is the rate of cash burn. For companies it is working capital. For households it is savings. Liquidity crises that remain unresolved morph into insolvency and bankruptcy. Companies have drawn on credit revolvers, raised financing where possible, and begun layoffs. Credit markets have broken down with spreads blowing out. For an economy like the U.S.—with an elaborate and sophisticated integration of finance and commerce—the downward spiral is vicious.

## The Lender of Last Resort

In this environment, the Fed on March 23<sup>rd</sup> acknowledged its role as the lender of resort and stated that it will boost its balance sheet by any amount needed to stabilize the Treasury market. The central bank made history by opening a new liquidity pipeline directly to the corporate sector with its Primary and Secondary Market Corporate Credit Facilities. In addition, the central bank indicated that it expects to announce a Main Street Business Lending Program for small- and medium-sized enterprises, aimed at keeping the credit lines open to them during the crisis and for sustaining employment. These measures aimed at getting liquidity and credit to the business sector are all in the right direction. Ultimately, the firepower that the Fed brings to sustaining credit lines could be dramatic if it is able to lever up against much larger funding support from the Treasury, which is expected would follow passage of the extraordinary fiscal support measures currently under discussion in Washington.

These dynamics underscore how different this crisis is from 2008-09, a comparison many are drawing. A breakdown in the financial plumbing during the Great Financial Crisis threatened a massive economic contraction. The economy stabilized only after the financial plumbing cleared—and with the help of a lot of fiscal stimulus. This time around it is the economic shock created by the lockdowns and curtailment of economic activity that has triggered the financial seizure. The Fed will work hard to minimize the blowback from the financial system to the real economy. But the contraction in economic activity at the root of the crisis won't end before government-imposed measures aimed at curtailing the spread of the virus are lifted, notwithstanding the size and scale of Fed initiatives or the breadth of fiscal policy being mustered to soften the downside.

## Reevaluating Containment Policies

The economic damage is not going to end before the lockdowns are suspended, which keeps the U.S. administration focused on timelines. There was a lot of eye-rolling over President Trump's weekend tweet about reevaluating the need for more containment policies at the end of this week. It is easy to be cynical. The U.S. administration downplayed the health risk initially and only presented a plan to attack the epidemic a little more than a week ago. Trump identifies his future electoral success with the economy.

My own view is that Trump is correct in deliberating on when and how he should pivot from his focus on containing the virus to getting people back to work. There is a practical limit to how long a full-scale lockdown can be put in place and I agree with the president that this period is measured in weeks, not months. Yes, quarantining and social distancing ultimately will resolve the pandemic. Yes, the U.S. was slow to respond initially and is already late to react. But the longer the economy is on pause, the harder it gets to start up again. Too long a lockdown could bring on a terrible economic outcome of bankruptcy and depression, no matter how much policymakers try to avoid it. That would lead to socioeconomic disruption on a scale at least equal to or worse than what we are living. From a human and psychological perspective, it is questionable how much people can sustain before they go crazy from the stress of fighting the phantom enemy, unnatural isolation, the inability to connect with family and friends, and the lack of income and purpose resulting from work shutdowns.

Trump anticipates push back at the state level when he finally announces that it is time to go back to work—another reason why he is thinking of ending the containment message sooner rather than later. This is what happened in China. Provincial governments—responsible for the health of their populations, as in the U.S.—resisted the central government's call for people to return to work. High frequency data show economic revival on its way in China with most people back to work, but it is uneven and many parts of the economy are still operating substantially below full capacity.

Factored into Trump's thinking is that this isn't 1918, despite all the comparisons with the Spanish Influenza epidemic. In the 100 years since that time, science and technology have advanced dramatically and the best minds in the world are working on solutions to the crisis. In addition, resources are being marshalled to help the healthcare industry boost capacity. Makeshift medical facilities are being set up across the country with assistance from the military. Factories are shifting and ramping up production of equipment needed to manage the case load like respirators. The ideal outcome would be rapid and mass escalation in testing. Learning to live with the threat of terrorism after 9/11 meant intense and widespread security screening at airports around the world. Similarly, learning to live with this threat could involve some combination of systematic temperature surveillance as is the case currently in several Asian countries.

All of this suggests that Trump is likely to pull the switch on reversing the containment strategies sooner rather than later, possibly some kind of return-to-work in stages. On the virus front itself, there is some good news: new cases have been down two days in a row in Italy, suggesting that flattening the viral curve to manageable levels involves weeks of containment not months. Any order to return to work might include an announcement for the older and more vulnerable segments of society to continue their isolation but for the bulk of the labor force to return.

## An End to Negative Sentiment?

The number of new cases will rise sharply in the U.S. over the next few weeks based on the pattern of infection in other countries—the economic data will be ugly. But asset market valuations are multiple sigma away from levels associated with any kind of return to normalcy. The pivot back to firing up the economy, coupled with all the current fiscal and monetary firepower in play, and more likely to come—argue for an end to the current negative sentiment in asset markets, sooner rather than later.

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