COVID-19 UPDATE: THE FIRST ORDER OF BUSINESS

Solve the health crisis, solve the economic crisis

Dominic Nolan, senior managing director of Pacific Asset Management LLC, provides his analysis below of the markets currently battered by the COVID-19 pandemic. In this fluid economic environment, it's important to note that this commentary was written on March 17, 2020

For the seventh straight session, the Dow Jones Industrial Average swung by more than 1,000 points. Including today, there have only been 14 days of 1,000-point swings in history. In addition to the extreme volatility, confirmed COVID-19 cases are now greater outside of China, the U.S. economy is close to shutting down, and market liquidity dislocations have increased. To help counter this, testing for COVID-19 in the U.S. should increase significantly over the next few days, lawmakers are expected to enact significant stimulus measures, and the Federal Reserve (Fed) is dusting off weapons from the 2008 financial crisis. As this all unfolds, how do we get our economy and markets through?

Health is the First Order

Resolving the threat to public health is how this crisis ends. In my opinion, understanding this paradigm is essential, as lower rates and more stimulus are subordinated to this objective. Flattening the epidemic curve reduces mortality rates and provides time for the global-health system to find treatments for COVID-19. As we are learning from other countries, the more aggressive a government is in reducing public gatherings, the greater the chance to reduce the pace of contagion. These decisions are now being made at city, state, and national government levels, which is encouraging given last week it was coming predominantly from corporate and agency levels.

As more data come in, indications are governments that were able to clamp down quickly and aggressively may reduce mortality rates to about 1% or less. Governments that were slow to act or less aggressive could be faced with mortality rates greater than 2%. Folks, that is a huge difference. A difference that could result in more lives lost than in some wars.

Economic Fallout Must Be Addressed

While the global medical community seeks treatment and a vaccine, the economic toll will most likely be devastating. Current estimates for second quarter U.S. gross domestic product (GDP) growth are ~-4%. Of note, Evercore ISI, an independent investment research and management firm, just reduced its estimate for second quarter to -10%. As a reference, the fourth quarter of 2008 saw an 8.4% (annualized) contraction in real GDP. This afternoon, Treasury Secretary Steven Mnuchin voiced that no action would result in 20% unemployment (unemployment stood at 10% after the financial crisis and peaked at 25% during the Great Depression). It seems the scope of the economic threat is being realized. At this juncture, Congress and the Treasury are key to bridging the economy.

The trick is addressing various segments of the labor force. At heart, we are a service-based economy, with many Americans living paycheck-to-paycheck. Stimulus needs to come in the form of relief, enough relief to prevent a dramatic increase in homelessness, hunger, or social disorder resulting from working Americans who will not have a source of income over the next few months. The next segment is small- and medium-sized businesses. My guess is that layoffs have already begun, and while revenue will be plummeting, fixed costs are not (hence the term). Access to capital or relief from leases, rent, or insurance costs could be the difference. Unfortunately, I think the small-business casualty will be immense as many mom-and-pop businesses simply do not have the cushion.

Regarding large corporations, would we really let Boeing fail? The country's only commercial airplane manufacturer and a defense contractor? Let's pose this question, what if a foreign entity wanted to purchase the company? Airlines, transportation, and energy are also critical. Now include restaurants, entertainment, hotels, and retail, among others. Those sectors employ millions of Americans. Without a mechanism to bridge the gap, companies would need to restructure and layoffs would soar, further worsening the economic problem. Conceptually, I believe something in the form of a "TARP 2.0" would be necessary. While not knowing the details, it will need bipartisan support or else it may not accomplish what needs to be done.

On March 14, the House passed the Families First Coronavirus Response Act. In just a few days, stimulus is now expected to be at least \$800 billion with talk of up to \$1.2 trillion. The bulk of the funds are expected to be in the form of direct payments to individuals and/or payroll tax cuts, \$250 billion would be for small business, and \$50 billion set aside for the airline industry. As of now, these elements and figures are conceptual, but provide a framework. I do not believe the current package is broad enough. However, I also believe this is a start to more.

Liquidity vs. The Fed

Liquidity continues to be a major concern, especially in Treasuries and the front end of the curve. Treasuries had been under pressure over the previous week as institutions needed to access dollar funding from banks, add large investment-grade companies coming to market with new debt issuance and expectations of massive deficit spending, the result is one of the worst days for U.S. Treasuries. Ten-year yields moved higher by 26 basis points to close at almost 1%, the highest level since March 3 when the S&P® 500 index was over 3,000. In addition to Treasury yields, the front-end of the curve is strained. Despite the Fed's rate reduction on Sunday, LIBOR remains elevated (over 80 basis points), and corporation's thirst for liquidity is causing stress in the commercial paper market. These elements are indicative of dollar-funding problems, which are contributing to a dramatic widening in short-term spreads.

The Fed is essential in easing the current liquidity problems, and it's using weapons enacted from Section 13(3) of the Federal Reserve Act. On March 17, the Fed resurrected the Commercial Paper Funding Facility (CPFF), which was originally announced in the 2008 financial crisis. This provides issuers of commercial paper a liquidity backstop. In addition, the Fed launched the Primary Dealer Credit Facility (PDCF) that "will allow primary dealers to support smooth-market functioning." Since Sunday, the Fed has cut interest rates by 100 basis points, promised to increase its balance sheet by at least \$700 billion, reduced bank reserve requirements to zero, lowered pricing on dollar swaps, injected further liquidity into the repo market, reintroduced the CPFF, and established the PDCF. That's a lot of work in three days.

Credit markets continue to be bombarded on multiple fronts: the economic slowdown, corporate uncertainty, dollar funding stress, and front-end market dislocations. The Fed's actions should help ease some of this, especially on the front end.

Conclusion: Near-Term Action for Better Long-Term Outcomes

Responding to the health crisis is the first order, but this requires time. Addressing economic fallout is the second order and requires broad action from governments. We must bridge the gap for the long-term health and resilience of our economy. Liquidity is the current order, and the central banks are acting in size and with urgency. These challenges can be addressed concurrently, but a misstep or lack of action would result in extending the crisis beyond a vaccination of the current pandemic.

We are in this as a Species

This isn't just Europe's, Asia's, or our problem. We are fighting a global pandemic, staring down a global recession, and working through global liquidity strains. I would be surprised if the research, trials, and treatment for COVID-19 comes from a single country. Global coordination is needed to accelerate the solution. These are unprecedented times with a difficult journey still ahead, but I believe if individuals act responsibly, companies support the greater cause, and governments coordinate and act quickly, we (humans) will prevail.

Definitions

One **basis point** is equal to 0.01%.

The **Commercial Paper Funding Facility (CPFF)** was established by the Federal Reserve to provide liquidity to U.S. issuers of commercial paper in the event that credit was not available in the market encouraging investors to resume lending in the market.

LIBOR (London Interbank Offered Rate) is the benchmark reference for interest rates that banks charge each other for debt instruments and loans.

The **Primary Dealer Credit Facility (PDCF)** was created by the Federal Reserve to allow primary dealers to support the availability of credit to businesses and households.

The **S&P 500 index** is a market capitalization-weighted index of 500 widely held stocks often used as a proxy for the U.S. stock market.

TARP refers to the Troubled Asset Relief Program created and run by the U.S. Treasury to stabilize the country's financial system, restore economic growth, and mitigate foreclosures after the 2008 financial crisis.

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