Financial markets ended 2019 on a high note with excellent returns across a broad cross-section of assets. We celebrated while acknowledging that with assets fully valued, something might go wrong. Three months later the world is living through a crisis only envisioned in fiction, and for which there is no living precedent in policy, personal comportment or financial damage. The COVID-19 epidemic crept up on the world and ravaged countries one by one. The disease started in China, where the now-accepted protocols for containment originated. Across the world, as these protocols have been adopted, the evolution of infections, deaths and recoveries has followed a similar pattern. The western world appears to be at or near "peak" contagions, a point at which economic reopening can be contemplated. Is there reason for optimism?

The Economic Damage

As the COVID-19 shut-downs became evident, economists altered their forecasts for the second quarter and all of 2020. One quarter ago, respondents to the WSJ Economic Survey expected growth rates near 1.8% for each of the first two quarters of the year. The same respondents now expect an economic contraction of -0.2% for the second quarter, although the timing of the survey suggests many replied prior to the harshest closures and have now cut their forecasts further. By quarter-end, many Wall Street economists suggested annualized declines of -20% or more. Most recognize the second quarter is a "lost cause," and are attempting to assess the likelihood and timing of a rebound. On Thursday, April 9, 2020, the newspaper published an article summarizing these economists' April forecasts. The expected second quarter growth (or decline) rate crashed to -25% at an annual rate, and the unemployment rate forecast plunged to 13% by June, the highest since the great depression of the 1920s. These numbers are staggering.

In current dollars, U.S. GDP was approximately $22 trillion at the end of 2019. We do not have first quarter numbers, although published data suggests growth continued into early March. With lockdowns beginning in March and likely lasting into May, the peak of the damage will occur in April. Forecasts of the magnitude of the destruction vary, with pessimists pointing to a decline in excess of 30%. These forecasts are presented in annualized terms. Converting them to current dollar value, results in expectations of a $1.1 to $1.6 trillion reduction in GDP during the quarter. Considering a good quarter of growth produces less than $200 billion of additional GDP, such numbers are hard to fathom.

Over the last four weeks (through April 16), claims for unemployment rose by over 22 million people. It is likely filings continue at an elevated rate until the end of April. At this figure, the reported May unemployment rate could reach the 13% forecast by the WSJ Survey economists. One mitigating factor is that many unemployed work in small businesses, like restaurants, that will likely hire them back once they can reopen.

Impressive Government Response

In response to the near collapse of financial markets as the virus unfolded, the Federal Reserve stepped in to assure liquidity. With two actions in March and one on April 9, after the passage of the CARES Act, the Fed took charge of the lending markets. The central bank's goal is to prevent credit markets from seizing up, and through a number of facilities, help bridge the economy's multiple sectors through the shutdown. As of April 9, 2020, the Fed had effectively guaranteed unlimited liquidity to the repo market, thereby assuring the Fed Funds Policy rate of zero would be met. Separately, the central bank promised unlimited purchases of U.S. treasuries and agency guaranteed mortgage-backed securities. In addition, the Fed created the following facilities, which will provide, if fully utilized, about $2.3 trillion in additional credit:

- A Primary Market Corporate Credit Facility (PMCCF) and a Secondary Market Corporate Credit Facility (SMCCF) to support investment grade companies' funding needs. The expansion of the SMCCF announced on April 9, added high yield ETFs and securities rated Baa3/BBB- as of March 22, 2020 as eligible collateral, effectively venturing the Fed into the realm of high yield securities. These facilities received $75 billion in capital from the treasury and will be levered 10 times to provide $750 billion in lending capacity to the markets;

- A new Term Asset-Backed Lending Facility (TALF) to support the asset-backed securities market. This is a key funding source for auto lenders, credit card issuers and other providers of short-term credit to consumers. This facility received $10 billion from the treasury and will be expanded to $100 billion. A similar vehicle was used effectively after the 2008 – 2009 recession;
- On April 9, 2020 the Small Business Administration's Paycheck Protection Program took shape with the Fed providing funding to credit institutions that issue the loans. The Fed will buy all qualifying loans from the issuing banks through a liquidity facility (PPPLF). Qualifying loans will have the guarantee of the SBA, thereby ensuring the Fed is not making loans directly, which it cannot do. The size of the appropriation for the SBA was approximately $350 billion, although there has been discussion of increasing it;
- A new Municipal Liquidity Facility which will purchase notes from eligible states, counties and cities. The treasury funded this facility with $35 billion and the Fed will make $500 billion of funds available;
- Also, on April 9, the Fed created a Main Street New Loan Facility to facilitate lending to small and medium sized businesses by (eligible) financial institutions. The Special Purpose Vehicle (SPV) for this facility will purchase 95% of eligible loans from the banks on a recourse basis. The treasury capitalized this facility with $75 billion and the Fed will expand its resources to $600 billion;
- In mid-March, the Fed announced a Money Market Mutual Fund Liquidity Facility (MMLF) to help money market funds with redemption requests, and expanded the facility on March 23 to include high quality municipal debt;
- Also, in mid-March, the Fed announced a Commercial Paper Funding Facility (CPFF) to aid a market that effectively shut down, and expanded that facility on March 23 to include high quality short-term municipal debt.

The Fed's facilities are massive and a helpful boost to confidence. To provide context, the Primary Market Corporate Credit Facility is about $500 billion in size. Last year, investment grade corporations borrowed nearly $1.3 trillion in the primary market. The PMCCF could finance 40% of last year's entire issuance, if necessary. The facilities are set up to provide resources equitably to "eligible borrowers." The Fed has no ability to take direct credit exposure so all of these facilities are structured as SPVs with equity capital provided by the treasury and eligibility criteria spelled out in the facility's description. The CARES Act provided the funding and authorization necessary for the treasury to capitalize the SPVs and regulators worked with the Fed to determine the funds each facility should provide. The treasury contributed about $210 billion in capital to these facilities, which are increased in size through leverage. One facility that is not levered is the PPPLF because the program contemplates loan forgiveness. The CARES Act included about $550 billion for the establishment and execution of all of these facilities.

The Coronavirus Aid, Relief and Economic Security (CARES) Act is an enormous government assistance package that attempts to help the most affected people, communities, and companies get through the lockdown. The Act's value is pegged at $2 trillion, the largest direct assistance package in the history of the country. While cited at $2 trillion, the delivery of aid includes direct cash refunds, some grants and deferral or forgiveness of obligations, substantial sums arrive in the form of concessionary loans. An approximate summary of the programs and their value is as follows:

- Support for individuals worth approximately $560 billion, consists of $300 billion in "refunds" to individuals, couples and families. Refunds are about $1,200 for individuals earning up to $75,000 per year and smaller amounts for individuals earning up to $99,000. About $260 billion goes to fund an expansion and extension of unemployment benefits.

- Support for corporations (large businesses) totals approximately $500 billion, with about $200 billion for the most directly affected industries, including airlines, air cargo and other travel and leisure companies. Much of the assistance in this group consists of loans, tax holidays, and other concessions, along with the Fed's programs noted above. It should be stressed that for this segment most of the outlays should not become permanent additions to the deficit.
- Small business support consists of the Paycheck Protection Program mentioned above. While this program is structured as a loan program, conditions that appear likely to be met by most applicants allow for forgiveness. In all likelihood, most of the program will add to the deficit.
- State and local governments are beneficiaries of about $340 billion intended to assist with the burdens of the health crisis. Part of this money goes to the Fed to capitalize the municipal assistance SPV, increasing the total funds available to States and Local governments to about $850 billion.
- Public health service providers including hospitals, community health centers, and other professional groups will receive approximately $154 billion.
- Finally, to support education, institutions including schools, universities and other learning/care groups get about $45 billion.

Given the severity of the economic contraction, the government's assistance is welcome and timely. At $2 trillion, the CARES Act appears to contribute about 10% of GDP to the economy, conceivably offsetting a $1.1 to $1.5 trillion erosion from inactivity. Unfortunately, handing individuals money and corporations loans will allow recipients to fulfill their immediate obligations, but it does not replace the productive activities that generate GDP.

What Comes Next?

As the world prepares to reopen, it is a relief the authorities acted forcefully to ensure the economy can bounce back quickly. The 2008 – 2009 recession produced irreparable damage because leverage in the system exceeded the economy's underlying ability to sustain it. In 2020, consumers, corporations and even governments did not have excess leverage. In this respect, the federal government and the Fed do not face moral hazard concerns as they attempt to bridge the economy. The 17 million unemployed, the world's airlines and hotels, and the nation's small businesses played no role in their fate. We believe the government's actions are both justified and properly targeted.

The western world is generally skeptical of Chinese data and government information. It is hard to deny, however, that the country went through its share of challenges to contain the virus. Since reopening, the economy seems to have made a robust come-back. Even a jaundiced view of their reports has to find solace in the published changes in their March Purchasing Managers Index (PMI). According to Caixin, the March manufacturing PMI rose by about 10 points to 50.1, and, more telling, the services PMI rose by 16.5 points to 43. Since services tend to be more severely hit in a lockdown, the data provides optimism for the west. Economists covering China have viewed the post-shutdown data encouragingly, and even cited them to support optimistic forecasts for second half growth in the U.S and Europe.

Invariably, pundits will question U.S. government actions once the size of the emergency programs gets reflected in deficit and monetary conditions analysis. After all, the Fed launched quantitative easing in 2008 to support a depressed economy after exhausting its traditional policy arsenal. The central bank's balance sheet exploded to over $4.5 trillion before the policy ended. The effort to return the balance sheet to a "normal" size achieved only a modest $600 billion reduction before COVID-19 hit. With an unlimited purchase guarantee, the Fed acquired nearly $1 trillion in treasuries by April 1, 2020 and grew the balance sheet to nearly $6 trillion. Before the virus is conquered, the central bank may well own $7 to $8 trillion of the government's debt stock. Given the likely time it will take the economy to recover 2Q's GDP loss, the Fed may not get the chance to reduce that asset for years.

Similarly, the CARES Act may not add 10% to the deficit, but it will likely take the deficit to at least 10% of GDP. Even with superior growth in the second half of 2020, many of the tax deferrals, loan concessions and subsidies will ensure the government's revenues come in well below their pre-COVID-19 levels. While these complicated fiscal issues will be worth debating in due course, it is essential the economy can get back on its feet quickly so the challenges for the country are not worse.

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GIA Partners, LLC

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