AN UNPRECEDENTED POLICY RESPONSE TO COVID-19

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The basic mission of monetary policy is to unfreeze dysfunctional credit markets and to ensure the continuous availability and flow of credit within the financial system. The $2 trillion fiscal package passed by Congress last week is designed to provide a bridge for individuals and small businesses to survive the disruption in cash flow that resulted from the shutdown of the economy. The basic objectives are to provide cash to small businesses, minimize layoffs, and prevent widespread bankruptcies.

Summary and Major Conclusions:

- Investors face four crucial unknowns: Timing the peak in the number of new coronavirus cases; estimating the duration of the current recession; projecting the pace at which the economy recovers from recession; and analyzing the ease at which the economy is restored to normal functioning.

- The public health crisis continues to worsen on numerous fronts, including rapid increases in the number of new infections and shortages of vital supplies. Conditions will likely worsen in coming weeks before reaching a peak during late April.

- The US faces a deep but brief self-induced recession, which can be attributed to the decision by government officials to endure a temporary shutdown of the economy in order to suppress transmission of the virus.

- The recession will end when economic output and spending hit bottom, which occur during June or July. This should be followed by a gradual acceleration in GDP growth during the remainder of this year, and a more robust recovery in 2021.

- The economy is fighting both a demand and supply shock: Consumer and business spending has been curtailed while production has been slashed and supply chains disrupted, with many workers homebound and businesses closed.

- Comparisons with the 2008 financial crisis are misguided on fundamental grounds. The 2008 recession was caused by massive economic imbalances — most notably two colossal bubbles in housing and credit — along with an insolvent banking sector.

- Conversely, the US economy entered the current recession in excellent health, with solid growth momentum and strong household and banking sector balance sheets.

- The basic mission of monetary policy is to unfreeze dysfunctional credit markets and to ensure the continuous availability and uninterrupted flow of credit.

- The $2 trillion fiscal package passed by Congress last week is designed to provide a bridge for individuals and small businesses to survive the temporary cash flow crisis that has resulted from the shutdown of the economy.

- The basic objectives of the plan are to provide cash to small businesses, minimize layoffs, and prevent widespread bankruptcies. The commitment on the part of policymakers is open-ended, which implies that additional funds will be forthcoming beyond the next month.

- In terms of an economic recovery, the highest priority of policymakers is to flatten the curve of new COVID-19 cases. The US will be entering a period of maximum new infections during the next two or three weeks, with a potential trend reversal by late April or early May.

- The good news on the medical front is that the FDA gave emergency approval to a COVID-19 diagnostic test that yields results in only five minutes. There is also medical progress on the therapeutic front, with the strong possibility of an anti-viral drug by the summer.

- The next highest priority is the stabilization of credit, by way of massive liquidity injections by the Federal Reserve. Following several days of profound weakness, credit markets have calmed since the Fed's bold actions of last week, although risk spreads remain unusually wide.

- Another prerequisite for economic stabilization will be concrete evidence of cooperation among companies in retaining workers as a quid pro quo for receiving emergency cash infusions from the government.

- The equity market is the quintessential leading indicator, discounting future trends well in advance of the news. Historically, the timeframe between the end of recessions and the onset of new bull markets has averaged three or four months.

- While it is impossible at this time to know whether the stock market bottomed on March 23, an analysis of previous cyclical bear markets strongly suggests that a bottoming process has begun, which could persist for another several weeks.

- A timeline of key developments over the next several months would include a peak in the number of new infections during April and a cyclical bottom in the US economy by June. Stock prices should anticipate the end of recession during April.

- There remain significant divergences in the equity market. Economically sensitive stock market sectors — such as industrials, materials, financials, and transportation stocks — offer far greater relative value versus defensive safe-haven groups.

The outlook for both the economy and the global pandemic worsened last week, most notably in Europe and the US. The domestic economy is already in recession, with GDP expected to decline in the next two quarters. World financial markets are likely to remain volatile and dysfunctional until there is better news regarding COVID-19. This week's *Economic Perspective* provides an update of developments on the economic, financial, policy, and public health fronts.

- Continued high levels of uncertainty resulted in further volatility in financial markets last week, although stocks staged a spectacular "relief rally" from deeply oversold conditions. Equity investors responded positively to very aggressive policy measures from the Federal Reserve and a $2 trillion spending/relief package approved by Congress.

- Both the economic and medical news worsened last week. The number of confirmed new cases in the US is approaching 175,000, while worldwide infections are approaching 700,000. Conversely, health conditions within China and most of Asia continue to improve.

- Investors face four crucial unknowns: (1) Timing the peak in the number of new COVID-19 cases in the US and Europe; (2) Estimating the duration of the current recession; (3) Projecting the pace at which the economy is able to restart and recover from recession; and (4) Analyzing the ease at which the economy is restored to normal functioning.

- The public health crisis continues to worsen on numerous fronts. The number of new infections is increasing at an exponential rate, while vital medical supplies remain in short supply. These include diagnostic test kits, masks, gloves, face shields, ventilators, respirators, and health care professionals. Conditions will likely worsen before peaking in late April.

- The number of cases in the New York City area could peak during the next two weeks, but outbreaks have begun in other major cities such as Philadelphia, Miami, Detroit, Los Angeles, Chicago, and New Orleans. The epidemic in Italy may be approaching a peak, with a possible flattening of the new infection curve in coming weeks.

- There is some good news on the medical front. The FDA gave emergency approval to a COVID-19 diagnostic test that yields results in only five minutes and can be used almost anywhere. Abbott Laboratories, the manufacturer of the test, said it plans to supply 50,000 tests a day starting on April 1. There is also progress on the therapeutic front, with the strong possibility of an anti-viral drug by this summer.

- The economic news was alarming on several fronts and is also set to worsen in April and May. Initial unemployment claims surged to an all-time high, implying a spike in the unemployment rate in coming months.

- The US faces a deep but brief ***self-induced*** recession, which can be attributed to the decision by government officials to temporarily shut down the economy in order to minimize risks to public health.

- The recession will end when economic output and spending hit bottom, which could be in June or July. This should be followed by a *gradual* acceleration in GDP growth during the remainder of this year, and a *more robust recovery in 2021*.

- *The economy is fighting both a demand and supply shock*: Consumer and business spending has been curtailed while production has been slashed, with many workers homebound and businesses closed. The result is a classic Keynesian ***demand gap*** that will widen before it begins to shrink during the second half of this year.

- *Comparisons to the 2008 financial crisis are misguided on fundamental grounds*. The 2008 recession was caused by massive economic and financial imbalances — most notably colossal bubbles in housing and credit — along with an insolvent banking sector. The 2008 downturn was a classic ***balance sheet recession***. The current downturn is a classic cash flow-induced recession.

- Conversely, the US economy entered the current recession in excellent health, with both solid economic momentum and strong balance sheets. The implication is that a repeat of the vicious ***deleveraging cycle*** that suppressed GDP growth in the aftermath of the 2008 recession will not be necessary following the current recession.

- The basic mission of monetary policy is to unfreeze dysfunctional credit markets and to ensure the *continuous availability and flow of credit within the financial system*. The Federal Reserve is determined to prevent the current liquidity crisis from morphing into a solvency crisis.

- The $2 trillion fiscal package passed by Congress last week is designed to provide a bridge for individuals and small businesses to survive the disruption in cash flow that resulted from the shutdown of the economy. The basic objectives are to provide cash to small businesses, minimize layoffs, and prevent widespread bankruptcies.

- The commitment of policymakers is ***open-ended***, which means continued cash infusions from the Treasury and the Fed for as long as necessary to keep individuals and small businesses afloat until economic growth resumes.

- In terms of the economic outlook, the highest priority of policymakers is to flatten the curve of new COVID-19 cases, followed by a plateauing of total cases and a gradual decline in each. *The US will be entering a period of maximum new infections during the next two or three weeks, with a trend reversal possible by late April or early May*.

- Investors should also monitor public health and economic news in China and the rest of Asia as a possible guide to future developments in the West. This incorporates both good news — a successful restarting of Asian economies — but also confirming evidence that the pandemic has not entered a second phase.

- *The next highest priority is stabilization of credit markets and a return to normal functioning*, supported by massive liquidity injections by the Federal Reserve. The ultimate damage to the real economy is predicated upon a return to stability in the credit markets.

- Following several days of profound weakness, credit markets have calmed since the Fed's bold actions announced last Monday. That said, risk spreads in the corporate bond, commercial paper, and mortgage markets remain unusually wide, although down from their peak on March 23.

- Government injections of trillions of dollars into the economy and financial system are necessary but not sufficient conditions for economic stabilization. It is important to closely *monitor the effectiveness of government agencies in ensuring that funds are distributed to those small businesses in desperate need*. It is also highly likely that there will be a need for additional funds in coming weeks and months.

- Another prerequisite for economic stabilization is concrete evidence of a positive response by companies in retaining workers, as a *quid pro quo* for emergency cash infusions from the government. *Minimization of layoffs is crucial in preventing a vicious downward spiral* as rising unemployment reduces consumption, which then further increases the number of layoffs.

- *The equity market is a forward-looking indicator that discounts future trends in advance of the actual news*. Historically, the timeframe between the end of recessions and the beginning of new bull markets has averaged three to four months.

- The 2009 equity bull market began in March, three months before the economic bottom in June 2009. In other words, *stock prices recovered in early 2009 at a time when GDP was in the midst of a steep decline*.

- While it is impossible to know at this time whether the stock market bottomed on March 23, an analysis of previous cyclical bear markets strongly suggests that *a bottoming process may have already begun*. A bottoming process is necessary for creating a durable foundation for the next bull market.

- The combination of gargantuan policy support along with extremely oversold conditions suggest that periodic equity market rallies could occur in coming weeks. However, the onset of a sustained stock market rally awaits evidence of a peaking in the public health crisis and easing of self-containment measures.

- In terms of a plausible timeline of developments over the next several months, I would envision a peak in the number of new infections during April and a cyclical bottom in the US economy in June. *As a reliable leading economic indicator, the stock market should anticipate the end of recession — and a sustained economic recovery — during April*. The implication is that a new equity bull market could begin within the next month.

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