Federated Hermes

Three-legged stool

Monetary, fiscal and social policy must work in concert to manage crisis.

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BOTTOM LINE

It's been a brutal month. Since hitting an all-time high on Feb. 19, the S&P 500 has plunged nearly 33% to Wednesday's intraday low. That temporarily pierced our targeted support level at 2,350, which was the Christmas Eve 2018 low. The volatility index (VIX) spiked to a 12-year high of more than 85 this week (from just 12 a month ago). The equity market swung 4% or more in either direction for eight consecutive trading sessions through March 18, breaking the previous record of six days from November 1929.

The economic news has begun to reflect the pandemic. The manufacturing indexes compiled by the Empire and Philly Federal Reserve bank plummeted sequentially in March by more than 34 and 49 points, respectively. Those amount to the largest month-over-month declines in the history of those data series.

Thursday's initial weekly jobless claims for the week ended March 14, the survey week for the March nonfarm payroll report, surged sequentially by 28% to 281,000 claims. But given the extreme measures we've taken over the past fortnight to shut down the U.S. economy in an effort to contain the coronavirus, weekly claims could easily approach or exceed 1 million new unemployed filers in coming weeks. In fact, Treasury Secretary Mnuchin warned that unless aggressive fiscal policy action is approved soon by Congress, the unemployment rate (U-3) could skyrocket from a half-century low of 3.5% currently to a worst-case 20% in coming months.

The economic and financial-market implications are potentially dire, collectively worse than 9/11, hurricanes Katrina and Sandy, and the bursting of both the technology and housing bubbles combined. So how do we as a country respond successfully to this epic challenge?

The governors of California and New York have shut down their states to nonessential activity over the past 24 hours, in addition to all of the other closures across the country that we've chronicled in recent weeks.

Ultimately, a successful approach to flattening the coronavirus curve must be three-pronged: monetary policy, fiscal policy and social policy. With good execution, the peak of the coronavirus in the U.S. may be at the end of April. But if we fail, this global pandemic could accelerate into August. Given that wide range of outcomes, then, many companies have pulled their guidance for 2020. To some degree, investors are flying blind.

To be sure, the trajectory of the coronavirus will rise sharply in coming weeks as testing increases. But we remain optimistic that the social-distancing and health-care policies in place will assist in Covid-19 following a pattern similar to China and South Korea, in which illnesses have already peaked. And with aggressive monetary and fiscal policy, the government's so-called "Bridge

Loan" will help the economy and the financial markets recover during the second half of 2020.

Here's our three-pronged framework for how we're monitoring the trajectory of this crisis:

Monetary policy: The Fed's all in On March 3, the Fed orchestrated a surprise 50-basis-point cut in the fed funds rate, taking the upper band down from 1.75% to 1.25%. It followed that on March 12 with a liquidity injection of $1.5 trillion into our banking system.

Then came the emergency meeting on March 15. Rather than wait for this past week's scheduled policy-setting meeting, the Fed cut rates by another 100 basis points to a 0.25% upper band. It also announced $700 billion in quantitative easing (QE), planning the purchase of $500 billion in Treasuries and $200 billion in mortgage-backed securities.

The Fed organized coordinated central bank intervention with the Bank of England, the Bank of Japan, the European Central Bank, the Bank of Canada, and others. It also created a backstop facility for $1 trillion in commercial paper, provided regulatory relief for banks, encouraged discount window borrowing, enhanced currency swap lines, among other moves.

Fiscal policy: Bipartisan work in progress On March 6, President Trump signed an emergency $8.3 billion health funding bill (Phase One) to facilitate lab testing and vaccine development. Phase Two became law on March 13, as President Trump declared a National Emergency and authorized $50 billion in funding to expand the social safety net. This covers free Covid-19 testing, two weeks of paid sick leave for all workers, increased Medicaid benefits, expanded unemployment insurance and emergency food stamps. Trump also announced topping off the nation's strategic petroleum reserve with cheap oil and suspending interest on student loans.

Phase Three is under discussion now, with a program whose size could range from $850 billion to $2 trillion. Key elements may include direct payments to individuals (perhaps limited to the bottom 90% of taxpayers), a payroll tax cut, small-business loans. It also may give relief to certain essential industries (such as airlines) in the form of preferred stock sales, so that the federal government will profit when these companies eventually recover. This is very contentious, as some members of Congress want to restrict the use of these funds to exclude executive compensation, share buybacks and dividends.

Middle class tax cuts and infrastructure spending are longer-term issues that are also under discussion. With benchmark 10-year Treasuries under 1% at present, we encourage the administration and Congress to issue 50-year or longer bonds as a low-cost funding mechanism.

Social policy: Isolation and health care Social distancing, constant hand washing and periodic surface cleaning are the keys here. Outside life as we knew it (work, school and entertainment) has been shut down for a month or more to contain the spread of the virus.

In the meantime, pharmaceutical and biotechnology companies are making rapid progress in dealing with the crisis: Roche has received government approval for a new, faster Covid-19 test; Becton-Dickinson is testing a fully automated Covid-19 screening system; Gilead is testing an anti-viral drug, "Remdesivir;" Moderna is testing a vaccine; Regeneron and Sanofi have an previously approved arthritis drug "Kevzara," which is being tested for off-label use for coronavirus. Bayer has an already-approved hydroxychloroquine drug called "Resochin," which works on malaria, lupus and rheumatoid arthritis, and is being tested for off-label use with coronavirus. We expect fasttrack approval from the FDA, if any of these medical developments prove to be more efficacious with lower levels of mortality.

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DISCLOSURES

Views are as of the date above and are subject to change based on market conditions and other factors. These views should not be construed as a recommendation for any specific security or sector.

S&P 500 Index: An unmanaged capitalization-weighted index of 500 stocks designated to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Indexes are unmanaged and investments cannot be made in an index.

VIX: The ticker symbol for the Chicago Board Options Exchange (CBOE) Volatility Index, which shows the market's expectation of 30-day volatility.

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