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SKBA Economic Update

Is There a Yellow Brick Road Out of Mnuchkinland?

Having passed the initial financial shocks from COVID-19 on the U.S. economy, are we now headed for the Emerald City or have we been waylaid by the Wicked Witch of the West? "Dorothy" — representing the fearful U.S. population — is anxious to find out.

It's tough to know for sure when we seem to reel from one COVID-19 surge to the next and one bailout to the next. Naturally, there's widespread blame and credit to go around for the current condition of the economy and financial markets — it doesn't all reside at the footsteps of Treasury Secretary, Steven Mnuchin, as the Wizard who supposedly possesses all the magical solutions. Yet it's time to take a look at the policies implemented — what has been essential, what was insufficient, and what was unnecessary and perhaps even harmful? Naturally, such an exercise employs 20/20 hindsight regarding such a unique challenge as presented by the first global pandemic in over 100 years.

"Shelter in Place" (SIP) orders were designed to flatten the curve of a rising virus caseload and its impact on hospitals where it may overwhelm ICU capacity, highlight insufficient PPE supplies, and severely challenge medical personnel to handle the surge. Outside of initial hotspots such as New York, this was successful, even given the tragic loss of life that we continue to see. Mistakes were made as the world's politicians and medical community learned important details about this new virus. Who knew in advance that China was less than forthright sharing important details on the origins of the virus, its severity and extent of its spread? Who knew COVID-19's exact method of transmission? Who knew the best way to treat cases when no cure or vaccine existed? Now with better, albeit still incomplete information, the nation's COVID-19 strategy is evolving. States and municipalities have been seeking to enforce, or at least encourage, social distancing, as well as advocating or requiring face coverings when this is not always possible. In fact, many of the nation's retailers are now requiring masks to enter their stores, including the largest retailers, such as Walmart, Costco, and Target.

Flattening the COVID-19 case curve matters more than anything else right now. If we don't flatten the curve, and the case rate explodes exponentially, economic activity will remain constrained. Either due to state mandates or fear the economic recovery will sputter to a halt. In this event, no amount of helicopter money or Fed monetization will be sufficient to aid the economy or financial markets.

After the recent surge in U.S. cases in the middle of June states have been seeking to enforce social distancing and the use of masks in an effort to contain the surge. Since mid-July, daily new cases appear to have plateaued nationwide and may be slowly declining. There are still areas of the country experiencing a resurgence in new daily cases, but even some recent hot spots have started to show signs of heading lower. If by the end of August cases and hospitalizations have receded to more manageable levels, this may become the needed bridge to a vaccine. These efforts buy time to research, develop and test vaccines and medications to manage the symptoms of the disease for those most acutely impacted. In this instance, the current debate about how much additional stimulus will be necessary won't matter as much. The economy appears to be spring loaded to recover once it is progressively allowed to reopen for business.

Given the widespread adjustment in how business is conducted to reduce transmission, the economy has adapted remarkably fast. When the initial surge in the virus appeared to be out of control, who knew the best way to help households and businesses survive during the mandatory shutdown of the economy? Such has been Steven Mnuchin the Wizard's thankless job — along with other advisors, the Federal Reserve Board, and Congress. With the impossibility of having time to adequately prepare for this crisis in advance, the rapid development of economic protection plans has resulted in numerous unintended consequences. Yet once SIP was put in place, the federal government had to act quickly to prevent the economic damage from spiraling into a depression.

Unlike the Great Recession of 2008-09, for which the seeds of financial crisis had been building for several years, this COVID-19 recession was deliberately induced by the government. The ex-post analysis of whether a company should be helped or not if they took on too much debt in the last few years (and therefore would represent a bail out) isn't the appropriate consideration. The government's response to the pandemic created the recession, regardless of whether or not companies should have taken on less debt over the past decade. This is not an easy conundrum to resolve.

Consequently, excluding the impact of Federal Reserve Board actions for the moment, the best plan to come out of Mnuchkinland (and Congressional compromise) has been the Paycheck Protection Program (PPP), worth roughly a half trillion dollars in support. Small and mid-sized businesses were provided with forgivable loans if they rehired staff. Much of the employment recovery in May and June can be attributed to the PPP's incentive to rehire employees by June 30th to earn the equivalent of two months of salary reimbursement and other business expenses. Fortunately, the June 30th deadline for rehiring was extended into August. The inherent assumption was that by June 30th, the virus caseload would be under control, albeit not eradicated. The latter requires the development and testing of a vaccine.

At this juncture, some helpful programs are about to expire, and forecasts of dire consequences are on the rise. Yet, when one looks at the financial and economic response to the pandemic, one should examine what has been essential, insufficient or unnecessary. Looking at the policies in the Cares Act, as well as the Federal Reserve Board, here's a try at sorting out some of the highlights.

I. What has been essential?
   a. The PPP program, which we believe should be continued.
   b. Fed supply of liquidity to markets that began to freeze up, such as the Treasury repo market, swap lines, bond markets and foreign exchange. This is one of the essential mandates of the Fed — to prevent panic (but not to pick winners and losers or buy specific corporate bonds).
   c. Financial aid, via partially forgivable loans, to the U.S. airline industry. Just reopening the economy after the shutdown would not immediately lead to a recovery of air travel. More than most industries, the recovery period is likely to be exceptionally long.
   d. Temporary rent and mortgage payment abeyance along with rules requiring no foreclosures or evictions. This includes the Fed's backstop for financial institutions that need funding to offset the loss of cash flow. Those impacted by job losses and/or reduced income are able to stay in their homes and apartments.
   e. Extended unemployment benefits for a longer duration than the normal maximum benefit.
   f. Financial support to the health care system and states to manage the requirements for increased testing, treatment and hospital care related to COVID-19.
II. What has been insufficient?
   a. The requirement that PPP recipients use 75% of proceeds to pay compensation, with little flexibility for businesses, such as restaurants, to cover rent payments that are often larger than payroll for such businesses.
   b. The PPP requirement that rehiring occur by June 30th (this was extended to August). Given the success of the rehiring trends in May and June and the halt to reopening plans in July, expected employment gains for July are likely to be meager, perhaps even less than 1 million new jobs.
   c. Insufficient PPP controls for fraud and the emergence of "shaming" companies that took out PPP loans. The "shaming" label has discouraged companies from taking money they may actually need. This is counterproductive. It is, however, inevitable that programs established so rapidly will not be able to establish sufficient controls to prevent all instances of fraud. The same is true of unemployment insurance benefits as many recipients likely did not actually qualify but yet received the extraordinarily enhanced benefits.
   d. Slow implementation and uncertain rules of the EIDL (Economic Injury Disaster Loans) and the Main Street lending facility, particularly as landlords need bridge loans while rent payments are withheld.
III. What was unnecessary and possibly harmful?
   a. Helicopter money. This is in our view one of least effective ways of helping individuals survive through the SIP. Rent and mortgage abeyance and the no foreclosure and eviction rules are more effective along with unemployment insurance. Just offered as a temporary stimulus to spending, there are no positive incentive effects, and with the SIP, little motivation to spend it either.
   b. Deceased Senator Everett Dirksen of Illinois is believed to have coined the phrase (on the Johnny Carson Show), "A billion here, a billion there, pretty soon, you're talking real money." Now it should be, "A trillion here, a trillion there, pretty soon, you're talking really big money!" The ease with which the Wizard (and any other characters such as the Cowardly Lion, Tin Man, and Scarecrow) agreed to $3 trillion (13% of real GDP) of aid supposedly for Dorothy's benefit is astonishing! It's an unnecessary overkill.

c. Dividing businesses into essential and non-essential. Rather than forcing the shuttering of so many businesses, requiring them to adopt physical separation, masks, outdoor restaurant service, plastic shields and the like probably would have been sufficient. COVID-19 didn't surge because the big retailers were open; the chains just got bigger as the smaller non-essential retailers headed for bankruptcy.
d. While the safety net of unemployment benefits is critical, paying laid-off workers more than they were being paid to work poses huge unintended consequences. The $600 per week was a bad idea to begin with even if some more modest weekly benefit might have been helpful without posing a moral hazard problem of incenting workers to stay unemployed. Employers have complained that they are having problems hiring workers.
e. Another $3 trillion of spending (even while some program extensions make sense) when at least $1 trillion of the first $3 trillion has yet to be spent.
f. The Federal Reserve Board's actual buying of bond ETFs, monetizing federal expenses, and injecting massive reserves into the system are dangerous, not healthy. Suppressing the yield curve such that the 10-year T-bond yield is stuck at just above 0.5% distorts financial markets, encourages irresponsible risk taking, has sent gold prices above $1,900 and threatens to tank the exchange value of the U.S. dollar for years to come — all bad policies with these unintended and unnecessary consequences.

With so much stimulus pumped into the U.S. financial system, if the COVID-19 crisis can be contained until the arrival of a vaccine or other prophylactic treatments, the economy, from its current depressed base, is ready to surge ahead due to depleted inventories, pent-up demand, and personal income recovery. From the perspective of election uncertainty, the two parties seem to agree on many issues this time around (although they couch their policies differently on issues such as government money for COVID-19 testing, research on treatment and vaccines, anti-China policies, trade negotiations, infrastructure spending and attacking social media companies). Even though significant differences exist regarding other issues, from an economic perspective, the election outcome may have less significance to the ongoing financial recovery.

Therefore, there is indeed a yellow brick road out of the COVID-19 mess, if we choose to take it. As for the other members of the cast — the Cowardly Lions stirring up fear, the Tin Men with tin hearts, the Scarecrows with chaff for brains and the Wicked Witches casting spells — we'll leave it to your imagination as to which political characters they represent.

Our very best wishes to you,

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