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Fast and Furious - Fed backs fiscal stimulus

Unlimited Fed support boosts confidence… but has side-effects

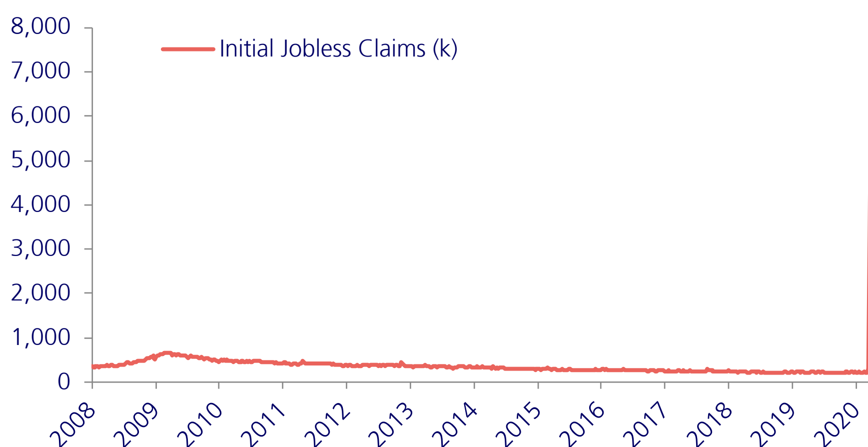
The US, largely unprepared, is hit with the full force of the COVID-19 pandemic. The combined efforts of the Fed, the Treasury and Congress will help to mitigate the economic impact and avoid a severe recession turning into a depression by supporting both households and firms. However, the support comes at the price of a soaring fiscal deficit, a massive increase in government debt and uncomfortable trade-offs in the future.

Source: iStock

Fiscal and monetary measures go a long way towards bridging the revenue gap as the economy comes to a full stop

The US, unprepared to a large degree, has been hit by COVID-19 with full force. While the longer-term impact on the economy will remain unclear for some time to come, early indications show that the drawdown is likely to be the worst since the Great Depression. More than 30 million people have lost their job since the beginning of the crisis, representing roughly one sixth of the US labour force. First quarter corporate earnings reported so far are about 10% lower than in the same period last year, although most of Q1 was hardly affected by COVID-19. Banks' profits have been particularly badly hit by provisions for expected credit losses. Many firms, mostly small businesses, face an existential crisis as revenues dry up. The lockdown measures to fight the pandemic cause tremendous economic damage, but both the Fed and the government have acted swiftly and decisively to mitigate the economic impact and avoid a negative feedback loop. By providing loans, grants and tax breaks to a large number of small and large businesses the combined measures will go a long way towards bridging the revenue gap caused by the lockdown.

More than 30 million people in the US lose their job



Source: Bloomberg

The Treasury and the Fed are working hand in hand to fight the crisis

The unprecedented economic downturn has been met with unprecedented monetary and fiscal measures and particularly close cooperation between the US Treasury and the Fed. While we welcome the swift action and close cooperation to avoid an even deeper economic crisis, the fact that the Fed is providing unlimited support creates a precedent for future downturns, may lower the threshold for future intervention and could even threaten the Fed's longer-term independence.

Congress is providing fiscal support amounting to more than 13% of GDP, and more is likely to come

The CARES act, which had allocated more than USD 2tn to households and businesses as well as to local and state governments, has recently been increased and currently amounts to more than 13% of GDP. The fiscal measures, combined with the Fed's support programmes, will go a long way in mitigating the expected shortfall in the economy,

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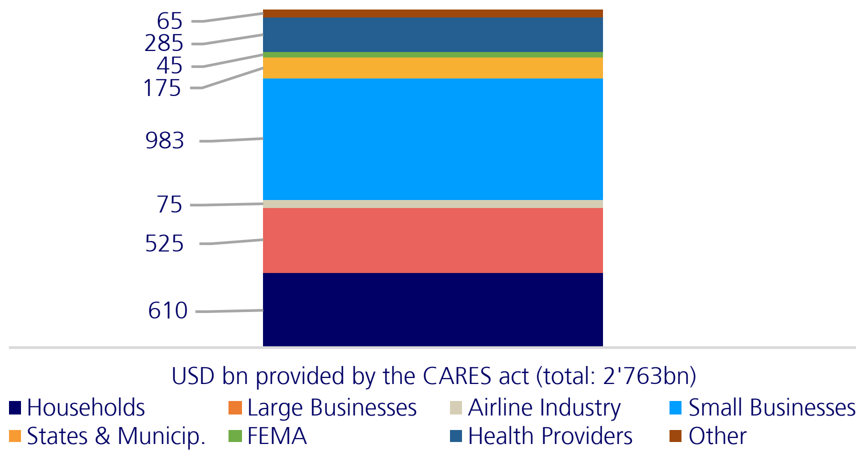
Broad-based fiscal stimulus



Source: CRFB

particularly if our assumption of a short, sharp shock followed by a solid rebound in Q3 is correct.

A significant share of the funds provided by the CARES act is targeted at keeping people employed or to increase unemployment benefits.

The Paycheck Protection Program gives firms an incentive to hold on to their employees or quickly rehire them

One of the main pillars of the CARES act is the Paycheck Protection Program (PPP), giving small firms an incentive to retain their workforce. Under the PPP, small businesses can apply for loans of up to USD 10 million. The loans will be fully forgiven when used for payroll costs, interest on mortgages, rent, and utilities (at least 75% of the forgiven amount must have been used for payroll). Forgiveness is based on the employer maintaining or quickly rehiring employees and maintaining salary levels. Forgiveness will be reduced if full-time headcount declines, or if salaries and wages decrease.

The program was so successful, and so needed, that Congress recently topped it up by another USD 310bn as the first tranche was used up quickly. Some additional conditions will be attached as well as it became clear that the money from the first tranche was not distributed in the most efficient way and did not reach those firms that are most in need of the financial support.

The government sends out millions of checks to support US households

Apart from the PPP, which will help to mitigate the impact on the labour market, the CARES act also provides substantial amounts of direct support for households. Probably the most visible crisis support for most US households are the checks being sent to millions of Americans, amounting to USD 1'200 per person with an income below USD 75'000 (and USD 500 per qualifying child). The direct stimulus payments will reach an estimated USD 290bn. In theory, sending out checks to households is a relatively quick and straightforward way to inject money into the consumer sector to support demand. In practice, however, there are already delays observable and some of the households who most urgently need the money will probably not get it for many weeks.

Given that the median household income in the US is about USD 63'000 a couple of thousand dollars can make a notable difference, although the experience with a similar stimulus program during the financial crisis in 2008/09 shows that a large part of the additional money was saved not spent. However, this time there could be a more meaningful impact on consumer spending if the uncertainty regarding the pandemic does not weigh on consumer sentiment for too long, particularly compared with the long-lasting effects of the financial crisis.

Economy expected to rebound in the second half of the year

We continue to believe that the US faces a sharp but relatively short-lived recession with a strong rebound in the second half of the year. It's a promising sign that the Conference Board's latest consumer expectations survey ticked up in April from its multi-year low while the present situation's perception fell to the lowest since 2013. A key challenge will be to slowly reopen the economy without risking a massive reacceleration in infection rates. To achieve this, states and the federal government should closely cooperate and monitor the development.

Unemployment benefits are topped up and extended

Another crucial part of the stimulus package is the USD 600 top-up of weekly unemployment benefits for an extended period of time combined with an expansion of the eligibility rules to include the self-employed. Considering that regular unemployment benefits can be USD 500 a week or less in some states an additional 600 dollars will make a notable difference. In fact, given that median weekly earnings in the US are USD 957, the overall unemployment benefit even exceeds the median wage someone could earn in many cases. From a purely financial perspective this could discourage some workers from actively looking for a job. As argued below, this disincentive is likely to be altered by any further extension of unemployment benefits.

The CARES act provides support to the business sector via tax cuts, deferrals, grants and loans

In addition to the PPP, which is likely to have the most direct impact on the labour market, the CARES act aims to support the business sector by providing tax relief through tax deferrals (delayed payments of federal social insurance payments), partially lifting caps on deducting losses and a number of other provisions.

Furthermore, the CARES act sets aside substantial amounts (roughly USD 500bn) for loans and loan guarantees. This includes funds set aside to be used in conjunction with the Fed to lend to businesses, non-profit organizations, states and municipalities. As these provisions serve as first-loss protection in the event of loan non-performance, the total amount of potential loans to the business sector will be levered up by the Fed to several trillion dollars.

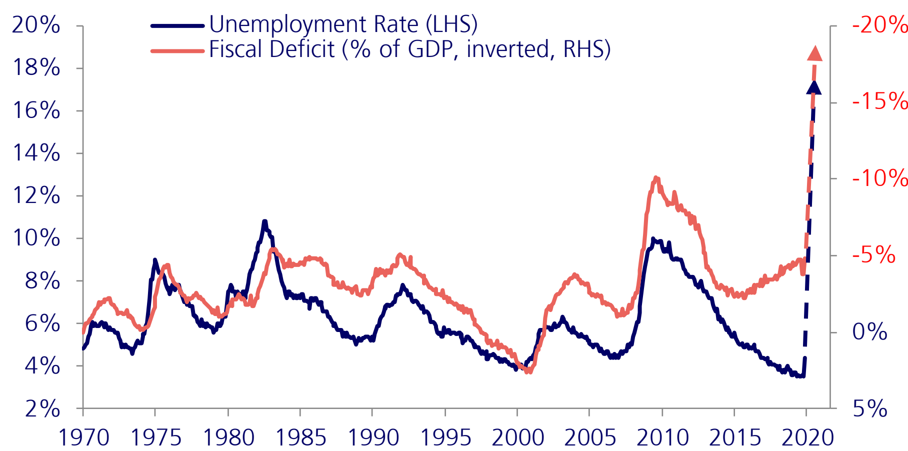
More fiscal stimulus is in the pipeline, including an increase in infrastructure spending

Overall, more than USD 2.7tn or roughly 13% of GDP have been provided so far as additional fiscal support to fight the economic impact of COVID-19. We expect this to be further increased as has just been done with the PPP. One likely path to do so is another extension of the unemployment benefits. The additional USD 600 per week will expire at the end of July. Since the unemployment rate is likely to remain significantly above the pre-

New hope – or just a blip?

Source: Bloomberg

The budget deficit and unemployment will soar



Source: Bloomberg

crisis level for the rest of the year, an extension of the additional unemployment benefits would help to mitigate the impact on consumer spending and support a rebound in the second half of the year. Given the potentially discouraging effect discussed above it is likely that any extension of additional unemployment benefits would be lower than the current USD 600.

In addition to the immediate life support provided by the CARES act we expect Congress to pass an increase in infrastructure spending as there is substantial bipartisan support. However, such an agreement is not expected in the near term and most of the related spending would probably not happen until next year.

The fiscal deficit and government debt will soar

With all this additional spending, not to mention the automatic stabilisers and the expected fall in tax revenues, the fiscal deficit, which was already high before COVID-19 hit the US, will soar to levels not seen since World War II. The Congressional Budget Office (CBO) expects the deficit to reach almost 18% of GDP in 2020 and to still be around 10% in 2021. That would be roughly three times what the CBO expected before the crisis.

Government debt would rise to 108% of GDP by the end of next year, from 79% at the end of 2019. However, the level of debt does not tell us the whole story. Whether the debt pile is manageable and how much it will weigh on future growth and spending crucially depends on the level of yields. Given the global hunt for yield and particularly the Fed's recent actions, debt service costs are not expected to rise substantially in the near term.

The Fed is providing unlimited support and as a result is likely to face tough decisions in the future

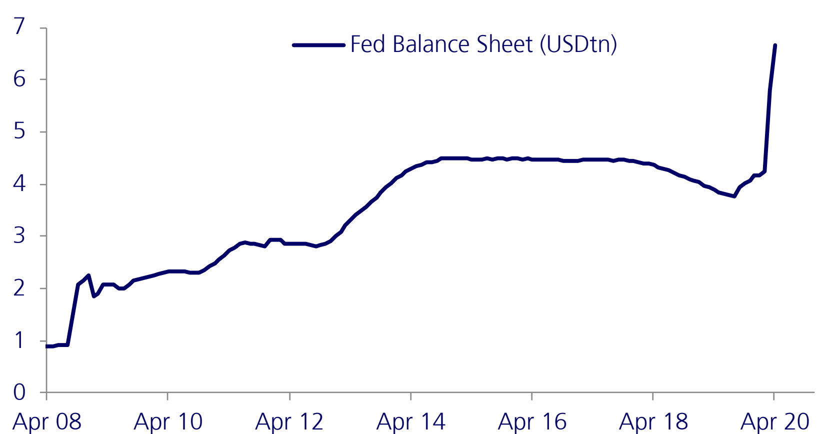
By announcing its willingness to buy unlimited amounts of government bonds and mortgage backed securities (MBS) the Fed implicitly put a lid on yields, ensuring that the public debt load, which will rise massively due to the support measures and the expected fall in tax revenues, remains manageable.

There will be a strong incentive to keep interest rates low and try to bring inflation rates up to let higher nominal growth slowly erode the level of debt relative to GDP. This may lead to challenging trade-offs in the future when the pandemic lies behind us, and the economic situation has normalised. The longer this regime lasts, the higher the risk of a misallocation of financial assets will be, as investors are trying to circumvent financial repression. On the other hand, given the massive rise in government debt it will be difficult for the Fed to end its support measures without disrupting the market, as it did during the taper tantrum back in 2013.

The Fed is also rescuing large parts of the corporate sector, which may weigh on productivity growth in the future

To avoid a potentially devastating negative chain reaction the Fed also announced a whole range of measures to provide liquidity to the business sector and other central banks. It recently upsized its primary and secondary market facilities for large investment grade companies from USD 200bn to USD 750bn, while announcing it could buy some high yield ETFs. Moreover, Fed purchases can now include so called 'fallen angels', i.e. bonds downgraded to high yield, provided they were investment grade rated on March 22, 2020 and remain within the BB rated bucket of high yield.

Ramping up the balance sheet to keep yields in check



Source: Bloomberg

While these Fed actions are a positive development, they only address liquidity but not solvency issues in a leveraged corporate world. We still expect default rates to pick up. Nevertheless, as with any central bank intervention there will be unintended side-effects. A broad-based support program to support large parts of the corporate sector will inevitably undermine the process of creative destruction that always takes place in recessions. The price to pay could be lower productivity growth in the following recovery.

Conclusion

In response to the severe degree of economic damage being wrought by COVID-19, the Fed, the Treasury and Congress have acted in coordination with unprecedented speed and extent to mitigate the impact on households, firms and states. While the massive increase in fiscal spending is a price worth paying to avoid a severe recession turning into a depression, the debt pile will weigh on the economy for years, if not decades. The Fed's role in fighting crises has been further extended and it will be difficult to unwind. The threshold for future interventions may be lower and the Fed could face challenging questions regarding its independence.

The crucial variable to observe will be inflation. As long as it remains contained, the Fed will be free to pursue its strategy of yield control. Should inflation rates recover once the situation normalises, negative real yields would redistribute wealth from savers to borrowers, including the government. By then, there will be challenging decisions and trade-offs and a strong incentive to try and reduce the debt burden with the continued use of financial repression and monetization of debt.

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