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The Difference that Policy Support Can Make

Key takeaways

- The Federal Reserve (Fed) recently announced multiple policy supports for financial markets. Simultaneously, the U.S. administration and congressional leaders have accelerated legislative proposals to help support the economy and the coronavirus' victims.
- Neither fiscal nor monetary policy steps—even aggressive steps—are likely to stop an economic recession, which we expect in the middle two quarters of this year.

What it may mean for investors

- For now, financial markets are likely to welcome these policy supports for sentiment. Looking ahead, the greater availability of credit, loans, and cash transfers should help households and businesses to tide over until the spread of the virus levels out, people begin to recover, and normal life begins to resume.

What has the Fed done?

The Fed has taken a number of emergency actions over the past two weeks. These include:

- Two separate emergency cuts in the federal funds rate
- Cutting the discount rate to 0.25%
- Significant increases in repurchase agreement (repo) facilities[1]
- A new quantitative easing program of securities purchases
- Expanded dollar swap lines
- Changes in regulatory requirements
- Restarting the Commercial Paper Funding Facility (CPFF), and
- Re-establishment of the Primary Dealer Credit Facility (PDCF).

[1] Repurchases are arrangements whereby the Fed buys securities from banks under an agreement that the bank will repurchase the securities later. The arrangement allows banks to access additional cash, as needed, on a temporary basis. The Fed increases its repurchases during times of stress, when banks typically demand more cash.

The federal funds rate is now at 0.00%-0.25% and has reached the zero lower bound. We believe it is unlikely that the Fed will move the fed funds rate target into negative territory.

New quantitative easing purchases amount to a Fed balance sheet expansion of at least $700 billion ($500 billion in Treasury securities and $200 billion in mortgage-backed securities). These purchases began on Monday of this past week with $40 billion of daily Treasury purchases and $80 billion of monthly mortgage-backed security purchases.

On Tuesday, March 17, the Fed restarted the crisis era commercial paper program. The Fed established the CPFF program under the authority of Section 13(3) of the Federal Reserve Act, with approval of the U.S. Treasury. This action should help to support prime money market liquidity and quality issuers.

On Tuesday evening (March 17), the Fed established the PDCF. This facility will help to support smooth market functioning and facilitate the availability of credit to businesses and households.

Was the 100 basis points in federal funds interest-rate cuts already expected by the markets?

Our federal funds interest-rate target had incorporated this 100 basis points (1.00%) of interest-rate cuts prior to the Fed announcement. While the Fed took aggressive action, the market already had come to expect similar rate cuts. The size and scope of the announced action was welcomed by market participants, but it is unlikely to provide a near-term economic boost. We believe that the Fed's actions were necessary, but the core issue remains a biological pandemic that needs to find resolution. Therefore, this additional monetary policy action is helpful, but it may not be sufficient to restart economic growth.

How will the Fed's policies help?

The Fed's actions were specifically designed to provide liquidity to the markets in order to assure normal financial market operations—while also supporting continued bank lending. The Fed is seeking to avoid a situation in which market liquidity or functionality is impaired. We believe that the actions the Fed has announced will help to support this objective, although more targeted actions may be necessary as conditions evolve.

What should people not expect?

Fed actions will treat, but not cure, the current crisis. We believe they also will not mark the beginning of an economic recovery. We are in a period in which businesses and consumers are fortifying their balance sheets and deferring unnecessary expenses. Lower interest rates and added liquidity will not get people to leave their homes or incentivize businesses to spend.

What bullets does the Fed have left to use?

The Fed has taken significant measures to support market liquidity. We do not believe that the Fed is likely to move the federal funds rate below zero; thus, this particular tool cannot be used to further ease monetary policy. The Fed does have a few other tools that it could use if needed. Specifically, it could further expand quantitative easing security purchases, which would support longer-term rate markets. The Fed also could continue to dust off crisis-era facilities, and Fed Chair Jerome Powell was clear that the Fed is keeping them in mind. Finally, the Fed could issue stronger forward guidance to guide forward-looking market expectations.

The actions already taken by the Fed are significant. By taking these actions, the Fed has fewer tools to further respond to financial stress in the future (if needed). While these actions should help financial market liquidity, they are unlikely to stimulate economic activity in the near term. These Fed actions will not clear up many of the questions around the length and depth of the current crisis.

Fiscal stimulus quickly is gearing up to be large

Fed action was needed to keep Treasury and credit markets functioning properly. However, it was not economic stimulus. Markets want to see a coordinated fiscal response. What does that look like?

On March 6, the first phase of federal assistance authorized $8.3 billion in spending to develop vaccines or to acquire medical equipment. The following week, the House passed the Families First Coronavirus Response Act (FFCRA), a second phase with a likely cost of approximately $100 billion. FFCRA was written to expand spending on health care, unemployment insurance, paid sick leave for some workers, and additional nutritional assistance for low-income families. While all of these are important measures, this targeted assistance is not macroeconomic stimulus, in the sense of a package that would support sentiment and spending across the economy. This bill has seen some delay, but the Senate turned to consideration of the bill on March 18.

To a third phase, and beyond

On March 17, the Trump administration held a press conference to propose ideas for a third bill, a large fiscal stimulus package. Financial markets reacted positively to the idea of a program of at least $1 trillion, or at least 4.8% of annual U.S. economic output (gross domestic product, or GDP). Such a size would put this stimulus on the same level as the $700 billion bank bailout and the nearly $800 billion 2009 recovery act, following the recession of 2008-2009. The elements being proposed include help for small businesses and aid for industries most affected, as well as direct cash payments to Americans.[2]

On March 18, the White House released a memo proposing $500 billion of that package to be two equal cash payments to individuals (to arrive on April 6 and May 18).[3] The administration wants checks of $1,000 each time, but with the specific link to the income and number of children in a household. The legislation is to be fast-tracked in Congress, in order to pass in the coming days. The credit facilities for large companies are likely to focus on industries particularly hard-hit by the abrupt stop in travel—including hotels, gaming, retailers, airlines, and aircraft manufacturers.

The president or congressional leaders could propose a fourth phase, and maybe more. Secretary Mnuchin added that additional transfer payments could be proposed later, if the national emergency persists.

Can Congress and the president pass and implement a stimulus law quickly?

Market reaction was positive following the fiscal stimulus announcement, and we believe that the leadership in Congress is capable of marshalling their parties to pass this legislation in the coming days. Any delay is likely to be met with reaction from financial markets and investors that are not inclined to wait patiently. Even if the proposal becomes law quickly, implementation could still be challenged by the need to cut a large number of checks in a

[2] "Trump Pushes $1.2 Trillion Stimulus, $1,000 Checks in Two Weeks", Bloomberg News, March 17, 2020.

[3] "Trump Wants $1.2 Trillion Stimulus; Senate to Vote on Virus Bill", Bloomberg News, March 18, 2020.

short period of time. For perspective, during the temporary tax reduction of 2009, it took two months to put checks in the mail.[4]

Conclusions

Our March 17 report addressed the question of what ultimately determines the length and severity of a global recession.[5] Neither fiscal nor monetary policy steps—even aggressive steps—are likely to stop a U.S. economic recession. There is still too much uncertainty about the ultimate spread of the virus, the degree of quarantining, and their collective impact on economic activity.

However, the policy measures being implemented and discussed now have two potential benefits for the economy and financial markets. For the immediate present, financial markets and investors are likely to welcome these measures as a support to sentiment, which has fallen sharply in the past month. In addition, the greater availability of credit for businesses should help many firms to tide over until the spread of the virus levels out, people begin to recover, and normal life begins to resume. Put another way, the economy may take greatest direct advantage of monetary and fiscal measures later.

[4] "Trump Wants to Send Americans More Than $1,000 in Two Weeks", Bloomberg News, March 17, 2020.

[5] "The Quarter the World Stood Still", Wells Fargo Investment Institute, March 17, 2020.

Risks Considerations

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