Untying the Knot

There are more questions than answers right now as the financial markets try to secure footing. Yesterday, the Dow fell -2,014 points, easily its largest single day point loss in history. The previous mark of -1,191 was set less than two weeks ago on Feb. 27. Just two business days later on March 2, the Dow climbed +1,293 points, establishing a new high for single day point gain. The next day, the Dow shed -970 points, before gaining back +1,173 points a day later, the second biggest single day advance in history. This wild stock market volatility is evidence of an untethered market. It isn’t clear where the economy goes from here, and it’s even less clear how the Fed will react. The FOMC meets next Tuesday and Wednesday in the most unpredictable Fed meeting in recent memory. It’s unlikely they take action before next Wednesday if only because last week’s 50 bps emergency cut only served to incite panic. If the hope was to support the plunging equity markets, it backfired. The bond market has now priced-in multiple rate cuts. In fact, bonds are now reflecting a worst-case scenario of near-term recession and the expectation that the Fed will cut to zero by summer.

The two-week plunge in bond yields has been unprecedented, as the entire yield curve has shifted 100 bps lower. The 30-year Treasury bond which closed at a then-record low yield of 1.915% on Feb. 21, traded briefly yesterday morning at 0.70%. The 10-year touched 0.31% early Monday, down from 1.59% three weeks earlier. Much of this represents a massive flight-to-quality. Both domestic and global investors are looking for the safe harbor, and U.S. government bonds are widely regarded as it. Some of the pressure has already eased and the yield nosedive has ended, but we’ve probably established a new low base. Given the current dismal outlook, a significant near-term increase in yields isn’t in the cards.

The most recent trigger was a weekend oil feud between Russia and OPEC nations. Over the weekend, Russia rejected a proposal to cut crude supply to stabilize prices and Saudi Arabia responded by threatening to increase production by as much as two million barrels per day and slashing prices by $6-7. This action sparked a 30% overnight drop in crude oil prices. Global energy demand had already been gutted as air and rail transportation grind to a halt in many countries, so an increase in market supply at this point would be devastating. The drop in energy prices has shifted the price pressure conversation from falling inflation to potential deflation, further fueling the scramble to lock-in fixed rates at any level. Central banks have historically combated deflation by cutting rates. However, this plan isn’t likely to be effective when yields are already so low.

Obviously, the underlying market concern is still the coronavirus, but while the threat to public health rises, the negative economic impact is growing exponentially. As the list of canceled events and travel grows, consumer and business spending dry up and the economy slows. With up-to-the-minute tallies of the infected and deceased on 24-hour news cycles, fear is ever-present. Concerns are reinforced as friends and neighbors stockpile canned food, water, batteries and toilet paper. The economic outlook is all over the place today, but the chances of recession, both globally and in the U.S. have risen sharply. Congress and the Trump administration are considering large-scale fiscal stimulus, which would take some of the pressure off the Fed, but the FOMC isn’t expected to sit idle next week. Yesterday, they took a first step by boosting daily liquidity with an increase in overnight repo operations from $100 billion to $150 billion. The markets appeared to shrug it off.

Please see disclosure on page 2.
The public reaction may well be a bit overdone as the virus seems to primarily affect those with compromised immunity systems. Senior citizens are most likely to catch the virus, while children seem to be spared. China has been successful in slowing the infection rate through containment, but the cost may be near zero first quarter GDP growth. As painful as it may be from an economic standpoint, this is the path the United States will follow. Contain the virus first and patch the economy later. The March and April data releases will be ugly.

On the bright (and admittedly shocking) side, the U.S. economy had been doing quite well. Last Friday’s unexpectedly strong February employment data pushed the Atlanta Fed’s GDPNow measure for the first quarter to +3.1%. It’s a long way from +3.1% to negative growth, but what had been unthinkable a week ago has suddenly become a real possibility.

**Market Indications as of 9:10 A.M. Central Time**

- **DOW**: UP 760 to 24,611 (HIGH: 29,551)
- **NASDAQ**: UP 269 to 8,220 (HIGH: 9,817)
- **S&P 500**: UP 77 to 2,823 (HIGH: 3,386)
- **1-Yr T-bill**: current yield 0.34%; opening yield 0.31%
- **2-Yr T-note**: current yield 0.44%; opening yield 0.38%
- **5-Yr T-note**: current yield 0.55%; opening yield 0.48%
- **10-Yr T-note**: current yield 0.64%; opening yield 0.54%
- **30-Yr T-bond**: current yield 1.11%; opening yield 1.00%

The economic outlook is all over the place today, but the chances of recession, both globally and in the U.S. have risen sharply.