HilltopSecurities
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# 2020 Q1 Economic Recap and Rate Outlook

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## The Beginning

The grueling final weeks of March made the first 91 days of 2020 seem like a lifetime. The year began with a sigh of relief as phase one of a China trade agreement was finally in place. Most expected any additional trade negotiations would be shelved until after the November election, while the Fed would quietly retreat to the sidelines allowing the economy to perhaps accelerate a bit in its record eleventh year of expansion. Employers, who might have been reluctant to hire amid 2019 trade uncertainty, would add workers to payrolls. The unemployment rate, which ended the year at 3.5%, was expected to remain within a tenth or two in either direction of that five-decade low as many employers continued to complain about a lack of qualified workers to fill skilled positions.

The housing sector, flush with inventory and bolstered by historically low mortgage rates, was poised for a solid year of growth. And, U.S. manufacturing, although still hamstrung by higher relative labor costs, would likely benefit from recently signed trade agreements. Consumer confidence was elevated, interest rates were favorable and nearly everyone who wanted to work was able to find a job. The economic outlook, although not robust, was nevertheless on track to enter a record 12th year of expansion.

The Bloomberg survey of U.S. economists indicated the Fed was likely to hold the overnight rate target steady at 1.50% to 1.75% for the next two years, while their median GDP forecast for the next eight quarters averaged +1.9% with little variance between periods.

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Most equity market experts anticipated moderation following the best annual performance in 22 years, but few believed the stock markets would actually retreat in 2020. Analysts polled by FactSet in early January estimated S&P 500 earnings would rise by a respectable +9.6% in 2020 on sales growth of +5.4%. The biggest hurdles for stocks and the economy were rising tensions in the Middle East, Boeing's decision to halt production of its 737 Max airplanes, and uncertainty surrounding the November elections. These wildcards to growth seemed significant at the time, but were mostly forgotten as the narrative of the quarter gradually shifted toward, and then suddenly became all about COVID-19.

## The Virus

On Dec. 31, researchers in China identified and began monitoring a new respiratory virus. On Jan. 7, the World Health Organization (WHO) identified it as a new coronavirus. On Jan. 11, Chinese media reported the first death. By Jan. 20, the first cases were reported outside of China and the next day, the first case emerged in the United States. On Jan. 23, Chinese officials quarantined Wuhan, a city of more than 11 million people and on Jan. 30, with over 9,000 people infected by the coronavirus, the WHO declared it a "public health emergency."

The following day, the Trump administration extended a limited travel ban on foreign nationals who had traveled to China in the past 14 days, excluding family members of American citizens and permanent residents. By Feb. 11, the WHO was referring to the virus as COVID-19, short for coronavirus 2019. By Feb. 23, COVID-19 was spreading at an alarming rate in parts of Italy and Iran. The next day, the Trump administration asked Congress for $1.25 billion to begin bolstering U.S. preparedness. At this point, there were 35 confirmed cases and no known deaths in the U.S.

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*Please see disclosure on page 6.*

On March 3, the Center for Disease Control and Prevention (CDC), after failing at its first attempt to produce a test kit, lifted restrictions, thereby allowing independent labs to begin testing while the CDC went back to the drawing board. On the morning of March 11, former Treasury Secretary Larry Summers told Bloomberg Television viewers that U.S. policymakers weren't fully grasping the gravity of the situation, calling the COVID-19 outbreak "potentially the most serious crisis of the century." Things got real for many Americans later that evening when it was announced that actor Tom Hanks and Utah Jazz all-star forward Rudy Gobert had tested positive. The immediate suspension of the NBA season was followed the next day by a massive and dizzying round of suspensions and cancelations that would ultimately shut down the National Hockey League, Major League Baseball, the men's and woman's NCAA basketball tournaments, Broadway musicals, theme parks, major concert events, and industry conferences. On Friday, March 13, the administration declared a national emergency. By March 15, the New York public school system, with 1.1 million students, announced it would be closing its doors. Within days, thousands more school districts across the nation would do the same while state and local governments began closing restaurants and issuing stay-at-home orders. On March 24, the Tokyo Summer Olympics were postponed, the same day that India imposed a 21-day lockdown on its 1.3 billion citizens.

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By March 26, the United States passed China and Italy to become the world's hardest hit country, with over 81,000 confirmed cases of COVID-19. And, on March 28, the CDC issued a travel advisory to residents of New York, New Jersey, and Connecticut to restrict all non-essential travel. By the time Virginia and Washington, D.C. had issued stay-at-home orders, an estimated 250 million Americans were shuttered in their homes and an estimated 180,000 were infected.

### The Fallout

According to the Bureau of Labor Statistics, just 29% of Americans are able to work from home. This includes more than half of information workers, but only one in 20 service workers. As a result, employees of restaurants and bars were among the first to lose their jobs. This alone is crippling to the economy as according to Forbes, the industry employs more than 11 million workers and generates nearly $880 billion in annual revenue. Leisure travel was also hammered early. Moody's estimated in late March that the U.S. hotel industry, which employs over 1.6 million Americans, was already losing $1.4 billion a week. According to the Transportation Security Administration (TSA), air travel was up +2.3% annually on March 1, before plunging to a -95% year-over-year decline by April 5. Airlines for America, a U.S. industry group, claimed the airlines drive more than $1.7 trillion in annual economic activity and support more than 10 million jobs, while the Centre for Aviation reported that most airlines in the world could go bankrupt by the end of May without government assistance.

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U.S. auto dealerships, which employ nearly 1.3 million Americans, are also among the early strugglers. U.S. sales of cars and trucks dropped from a 16.3 million annual unit pace in February to a pace of 11.4 million in March. Since most auto sales associates work on commission, the hit to income is immediate. On a related note, the total number of Uber and Lyft drivers in the U.S. ranges between 1.5 and 2 million. There are few recent statistics on gig employment, but judging by America's now vacant streets, most of these shared-ride drivers should be considered among the unemployed. Even industries that appeal to much narrower portions of the population are in trouble. The casino gaming industry contributes an estimated $260 billion to the U.S. economy, while the cruise industry adds over $50 billion annually. The oil industry has been bloodied by not only a plunge in global demand for crude, but also by an untimely price war between Russia and Saudi Arabia. In short, very few workers are unaffected.

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The stock markets were slow to grasp the potential severity of the crisis, but reacted violently when it finally became apparent. After reaching fresh highs in February, the record 11-year bull market ended in March. The S&P 500 closed at a record 3,386 on Feb. 19 before beginning a 23-day nosedive that would ultimately hack away almost a third of its peak value. Market volatility was dizzying with the S&P up or down 7% or more five days in March, while a move of less than 1% occurred just once during the month. For the quarter, the S&P lost 20%, while the Dow lost 23%, the biggest first-quarter drop in its 135-year history. It was also the largest decline in the Dow for any single quarter in 33 years.

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Normally, economists would watch the data closely for signs of a slowing trend. In this case, it was obvious that an extreme contraction was already at hand. Economic releases in March (calculated from February data) had become instantly stale and virtually meaningless. A good case in point was consumer confidence. Even though the Conference Board's overall measure sagged in March, the present conditions component was the highest March reading in 19 years. It's remarkable that Americans surveyed less than a month ago were reportedly optimistic over their present situations. That optimism would fade fast.

When the more timely weekly numbers started to trickle in by late March, they were both shockingly bad and totally expected. First time filings for unemployment benefits were just 211k for the week ending March 6, but exploded to 3.3 million two weeks later. This was more than five times the previous record high for claims. The following week, the number of Americans filing for unemployment benefits would more than double to 6.65 million. Anecdotal evidence suggests another 15 to 20 million layoffs in April. If weekly claims are any indication, the official unemployment rate could more than triple in April. Economists expect combined job losses in March and April alone will exceed the 22.8 million jobs created over the entire last decade.

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Bloomberg lists 160 different scheduled economic releases for April, but with the exception of employment-related reports, very few of these will really matter. Recovery doesn't begin until the virus is contained and people are able to return to work. Between now and then, the data will be extremely ugly.

## The Response

By the end of February, many politicians and Fed officials had expressed concern over COVID-19, but for the most part, alarm bells weren't yet sounding. Fed officials indicated they were monitoring the risks and would act if COVID-19 were to threaten the economy, but also reiterated their belief that three "insurance cuts" made in 2019 would provide enough of a cushion to withstand the virus impact. At the end of February, Fed Vice Chairman Richard Clarida and St. Louis Fed President James Bullard were still signaling a wait-and-see approach, while Jay Powell had just expressed public concern and a willingness to act. A few days later, in an emergency meeting of the Federal Open Market Committee (FOMC) on March 3, Fed officials announced a half point cut in the overnight rate target. Less than two weeks later, they cut again, this time by a full percentage point, dragging the overnight target rate back to zero.

Most people had believed once the Fed cut to zero, they'd have used up all of their ammunition. A number of Fed members had indicated as much in recent months, but as it turned out, there was quite a bit to be done. In addition to the rate cuts, policymakers at the FOMC:

- Sliced the discount rate to 0.25%…and encouraged banks to borrow
- Cut the bank reserve requirement to zero…and encouraged banks to lend
- Cut interest on excess reserves (IOER) to 0.10% discouraging banks from holding reserve balances
- Reinitiated quantitative easing (QE) with unlimited purchases
- Provided massive support to the repo market with both overnight and term operations
- Created a commercial paper funding facility to provide liquidity to CP issuers
- Established a money market mutual fund liquidity facility to provide liquidity to money market funds
- Created a primary dealer credit facility to support the market-makers

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- Formed corporate debt credit facilities to support both primary and secondary markets
- Established an asset-backed securities loan facility to support securitization
- Allowed global central banks to exchange Treasury holdings at the Fed for U.S. dollars

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The Fed balance sheet, which was already bloated by historical standards, climbed by over a trillion in a five-week period to $5.2 trillion, and will certainly move much higher…but this (too) doesn't matter. The Fed is hyper-focused on making sure there's enough water on hand to put out the fire; and they've made it a lot less expensive to rebuild anything that gets damaged along the way. Either directly or indirectly, through its backstop programs, the Fed is now standing behind just about every type of security, but the equity markets were still being pummeled. It would take massive fiscal policy action by Congress to stabilize the markets.

This took longer, but the Coronavirus Aid, Relief and Economic Security Act ("CARES Act") was finally signed into law on March 27, authorizing approximately $2.2 trillion in assistance to combat the virus and its effect on the economy. It was intended to provide immediate cash to families and individuals, loans for small businesses, support to medical providers, and relief for companies and industries most severely impacted by COVID-19. Although summarizing the almost 900-page relief act in a few paragraphs is impossible, some noteworthy highlights include:

- A direct cash payment of $1,200 per adult and $500 for each child, subject to income limitations
- Expanded unemployment benefits covering a wider range of workers, extending the maximum term from 26 to 39 weeks and increasing check size by an additional $600 per week for up to four months.
- Ability to withdraw 401k funds early without penalty for virus-related challenges
- Suspension of government student loan payments until September 2020
- A paycheck protection program to encourage small businesses to retain their employees
- $450 billion in emergency lending targeted for businesses, states, and cities, including support for the airlines and "firms deemed critical to national security."
- $150 billion to state and local governments in the form of a Coronavirus Relief Fund to assist in the healthcare emergency

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Although the CARES package more than doubles the amount granted by Congress in 2009 to stabilize the U.S. economy during the financial crisis, many believe it's inadequate for the COVID-19 crisis. St. Louis Fed President James Bullard, anticipating a severe second quarter GDP plunge, told CNBC that he sees the act as only "temporary relief" and not a stimulus plan per se. Many seem to share his belief, expecting that additional stimulus will eventually be introduced. It's also quite likely that the Fed's programs and the provisions of the Act will evolve over time. For now, the CARES Act is simply intended to keep individuals, businesses, and municipalities afloat until the broad economy reopens.

### The Bond Market *(see table on page 5)*

Record lows were established all along the yield curve in March as investors fled stocks and other risky assets for the safety of government securities. The Fed's rate cuts had an obvious impact on the short end, but market panic and low inflation expectations drove the long end. The 10-year Treasury-note, which began the quarter yielding 1.92%, fell briefly to 0.31% intraday after the Fed's first emergency cut. For several days in March, all Treasury securities maturing in 2020 were trading at negative yields. The extreme pressure on bonds has subsided along with the panic, while additional Treasury supply has helped lift yields off their lows.

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### Q1 Interest Rates

| | | Fed Funds | 3 mo. T-bill | 12 mo. T-bill | 2 yr. T-note | 5 yr. T-note | 10 yr. T-note |
|---|---|---|---|---|---|---|---|
| Last | 12/31/2019 | 1.50% - 1.75% | 1.55% | 1.60% | 1.57% | 1.69% | 1.92% |
| High | | | 1.57% | 1.57% | 1.58% | 1.67% | 1.88% |
| Low | | | -0.13% | 0.08% | 0.23% | 0.38% | 0.54% |
| End | 3/31/2020 | 0.00% - 0.25% | 0.06% | 0.15% | 0.25% | 0.38% | 0.67% |

Source: Bloomberg.

### Economic and Interest Rate Outlook

The economic outlook has never been more uncertain. By quarter end, an estimated 100 million American workers were subject to stay-at-home orders with just one in four having a job that allows them to work remotely, according to the Bureau of Labor Statistics. As a result, there will be significant layoffs. In the simplest of terms, when people aren't working, they don't spend…and consumer spending is the engine that drives the U.S. economy. Right now, that engine has stalled.

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At the time of this report, the president and the administration were still targeting May 1 as the date to reopen at least a portion of the economy. However, few are onboard with this early exit as health officials warn relaxing the restrictions too soon could significantly increase the number of virus-related fatalities. So, it could conceivably be months before employers open their doors.

The first positive indication of a turnaround will be fewer layoffs and then signs of people returning to work. Once displaced workers are again earning a paycheck, nondiscretionary spending should pick up, and with it…economic growth. But, any improvement is on an undetermined future timeline. At present, the forecasts are ugly…and all over the place. Bloomberg Economics expects a budget deficit exceeding $2.4 trillion this year with the possibility of additional fiscal action pushing it to $3.5 trillion, or 16% of GDP. Not good, but completely necessary.

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Despite massive government support, the Congressional Budget Office (CBO) forecasts 10% unemployment and a 28% annualized second quarter GDP drop, while Goldman Sachs sees 15% unemployment and a 34% decline in second quarter GDP. St. Louis Fed President James Bullard mentioned the possibility of 30% unemployment and a 50% plunge in second quarter annualized GDP growth if the shutdown lasts all quarter. All of these dire predictions include a substantial rebound in the second half of the year, which indicates across-the-board hope that COVID-19 will be contained sooner rather than later. Unfortunately, as Dr. Tony Fauci, the nation's leading expert on infectious diseases has said on several occasions "we don't make the timeline, the virus makes the timeline." So we wait…

In the meantime, interest rates are likely to remain at, or near record lows for the remainder of 2020. In fact, it's hard to imagine a scenario in which the Fed would be forced to tighten monetary policy over the next several years. As the national debt explodes, there will be some solace in the idea that debt service costs will be contained.

The second quarter is shaping up to be considerably worse than any recession since the Great Depression, but the enormous lifeline provided by the Federal government affords plenty of hope. History will ultimately document how this all plays out, but we'll be living through it.

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*It's gonna be a bumpy quarter.*