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Battle of fiscal stimuli

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Breaking down the rally

Markets have rebounded strongly off of their COVID crisis lows. Our view was that Fed policy and Congressional fiscal stimulus would be sufficient for a move to about S&P 2800. In our view, the rally we've seen can be broken down into three phases:

1. 2200 to 2600: The Fed backstopping credit markets fixed the financial "plumbing", in an environment where the margin calls and rush to liquidity were so acute that even Treasuries were being sold during big risk asset selloffs.
2. 2600 to 2800: Congress's CARES Act "made whole" a large portion of immediate income losses, in an environment of unemployment rates skyrocketing to historic highs.
3. 2800 to present: A "void" in actionable macro newsflow creating a battle between underinvested bears and "V-shape recovery" bulls, in an environment where some pre-COVID trends have accelerated, providing tailwinds for the megacap tech companies with the biggest weights in indices.

COVID has "reset" some trends and accelerated others. Consumption and investment tied to large indoor gatherings, like at restaurants, entertainment venues, and high-density office spaces have been substantially "reset". However, consumption and investment tied to digital utilization, like streaming, online delivery, and business software have only accelerated. Interestingly, many of the beneficiaries of the "work-from-home rally" are likely to see this COVID-induced demand shock become increasingly permanent, as the switching decisions by both households and companies are unlikely to reverse as we "normalize".

We saw initial signs of this in China, which had an earlier outbreak. Companies like Alibaba saw their shares have a smaller correction during the COVID crash than they did during the trade war. And the large weight of these megacap tech companies helped keep overall indices supported. Similarly, the big five megacap tech companies in the US account for about 20% of the S&P 500 (which is a market cap-weighted index). As such, the tailwinds from the "work-from-home rally" have supported overall indices far more than the underlying macro backdrop would typically imply.

Mixed in with these dynamics is the issue of active vs passive flows. One big pre-COVID trend that has, thus far, only accelerated, is the dominance of passive strategies over active strategies. Indeed, active managers reduced risk quite a bit during the COVID crash, and have only recently started to increase risk exposures again. Meanwhile, flows into passive strategies have continued unabated, as the initial COVID macro shock was far more burdensome on employment and income in the lower-end of the income distribution, while higher-end incomes (and their 401k flows) remained supported by the ability to work from home, as well as the Fed's credit backstops to their employers. Furthermore, the global stock of "excess savings" (especially in Asia) also provide another large set of "passive flows", primarily into US quality assets, exacerbating these dynamics.

First- vs second-order effects

A common explanation of the strength of the risk asset rally off the lows has been about policy. However, we don't think policy has been a strong driver of risk asset strength since about S&P 2800. Indeed, we believe that policy thus far has been sufficient only to offset the first-order shocks by the COVID crisis (immediate consumption). Whether second-order effects emerge, whether current policy sufficiently offsets them, and whether there is the political will for more fiscal stimulus in the US are key questions going forward.

Our analysis of the macro landscape suggests that a large share of income losses have been offset by fiscal policy. The unemployment insurance expansion provision in the CARES Act was especially robust for households in this regard, as households on the lower-end of the income distribution saw almost complete offsets to their income losses, and indeed some of the furthest down on the income distribution even saw offsets that were greater than their prior incomes. This type of progressivity of fiscal expenditures, especially with respect to households, is a quite potent cocktail for weathering the first-order consumption shock.

However, the plunge in consumption because of the decline in employment and mobility due to COVID is not the only potential macro consequence of the crisis. Even with offsets to the first-order shocks, metastasis can emerge ("hysteresis" in economic parlance) across economic sectors. We are focused on three key areas, where the first-order shock can accelerate into deeper and broader second-order shocks:

1. **State and local budgets**: unlike the federal government, state and local governments don't have monetary sovereignty (since they don't have a central bank that is the monopoly issuer of the currency their debts are denominated in, they face a hard budget constraint), so the shock to tax revenues is likely to lead to reduced spending, including for safety nets.
2. **Corporate capex**: even with the first-order offsets by fiscal policy, corporates find themselves with excess capacity, and are likely to utilize existing capacity before engaging in new capex, which reduces the income for other corporates (one company's spending is another's income).
3. **Layoffs moving up the income ladder**: the initial COVID shock was strongly disproportionately weighted toward the lower-end of the income distribution, but as the crisis has persisted, the accumulated income losses are growing, suggesting that layoffs are beginning to move up the income ladder into employment at larger companies.

Our analysis suggests that fiscal policy thus far hasn't been sufficient to offset these second-order risks. In fact, the Payroll Protection Program (PPP) wasn't sufficient to prevent an accumulated $60 billion shortfall in income and employment taxes withheld, since mid-March alone, as the image below (from New River Investments' Guillermo Roditi Dominguez) shows.

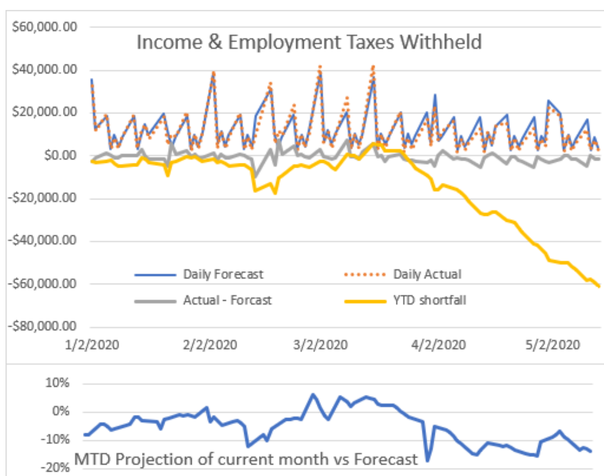

Figure 1. *Income and employment taxes withheld shortfall vs 2019-implied forecasts. Source: Guillermo Roditi Dominguez / New River Investments.*

The existence and magnitude of second-order shocks is tough to read until future data releases emerge, because of the swiftness of the shock and the lags involved in data collection and distribution. We believe the earliest signs of any broader metastasis would be in the May PMIs (Purchasing Manager Indices) released on June 1. We expect the June through August period of data releases to provide a lot more context about these dynamics.

Generally speaking, however, we don't believe that robust offsets to first-order shocks are sufficient for a V-shaped recovery in activity. And aside from the mechanical second-order effects, there's likely to be a push toward precautionary savings among households and businesses, which is for example why we see Chinese production recovering strongly, but a more muted recovery in Chinese consumption. Axiomatically, this necessitates even higher fiscal deficits to keep profits growth supported.

The return of "fiscal cliffs"

The eviction moratoria across the country have helped households maintain their place of residence while dealing with the COVID shock to their ability to pay rents. Most of these moratoria expire sometime in June, after which housing financial obligations become more acute. Additionally, the expanded unemployment insurance by the federal government, which supplants the state unemployment insurance benefits, sunsets at the end of July.

We view these as potential "fiscal cliffs", as backstops to household finances roll off. It will be vital to get another stimulus passed in the next six weeks or so, otherwise the employment hits become more acute to general consumption. Both parties have begun the process of staking "initial positions", but there appears to be a lot of room between them at present. The White House has pointed to the reopenings as a reason to avoid an extension of the unemployment insurance expansion, and Republicans in the Senate have pushed back against the idea of renewed stimulus.

We remain of the view that renewed markets volatility is likely to be the catalyst for another fiscal package compromise across the aisle. As long as markets remain robust, we think another fiscal package is tough to get through both Houses, although we do think it will be macroeconomically necessary.

Below is a chart showing the potency of the expanded unemployment insurance benefits, using three states as benchmarks, from economists Patricia Anderson and Philip Levine. Much of the lost income from unemployment has not only been replaced, but for the lower-end of the income distribution, has been even more than offset. This likely needs to persist beyond its sunset date, in order to keep the macroeconomy robust to second-order macro effects.

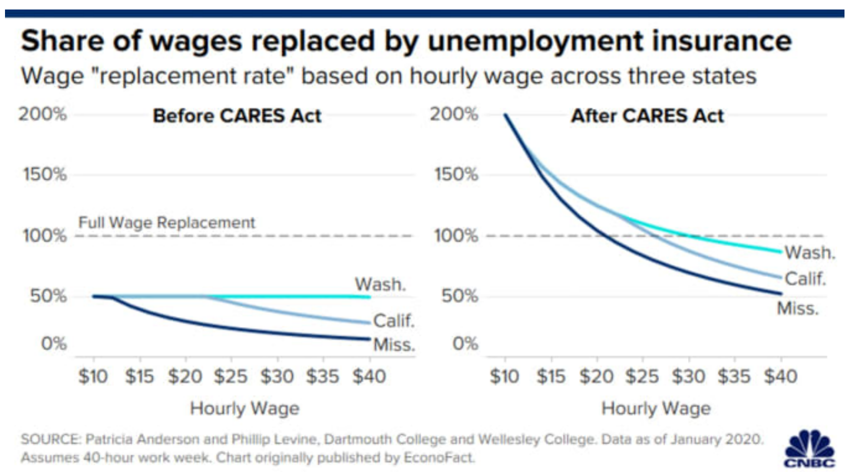

Figure 2. Shares of wage replaced by unemployment insurance, pre- and post-CARES Act expansions, in Washington, California, and Mississippi. Source: CNBC, Patricia Anderson, Philip Levine.

Better understanding of the virus

One key factor behind the strength in risk assets compared to March is that the virus itself is much better-understood now. It's increasingly clear that the biggest transmission risks aren't from casual contact outdoors, but rather congregated indoor spaces, particularly those with indoor air circulation. The virus itself is probably not airborne by itself, but indoor air circulation seems to distribute it across indoor areas. Repeated exposure and high viral loads seem to be necessary for strong transmission events, like in churches, call centers, restaurants, and nursing homes. This also helps to explain why even younger physicians in Wuhan earlier on in the outbreak were able to develop severe symptoms and even die, despite their demographic profiles.

We think this bodes well for reopening outdoor activities, and ending shelter-in-place. However, restaurants, bars, churches, crowded offices, and similar indoor spaces continue to present significant transmission risks. We are concerned about the reopenings of these types of facilities, especially since compliance appears to remain low even in the more aggressively-reopening states. The outbreaks in meatpacking plants across the country have been responsible for much of the recent upticks in new case counts in different states, similar to the role nursing homes played in New York and New Jersey.

A recent South Korean study of a call center that experienced an outbreak highlights the risk of indoor transmission via air circulation. The image below shows the floor plan of the office space, as well as highlights in blue the desks that showed confirmed cases. These line up well with the path of air circulation, given the distribution of air vents.

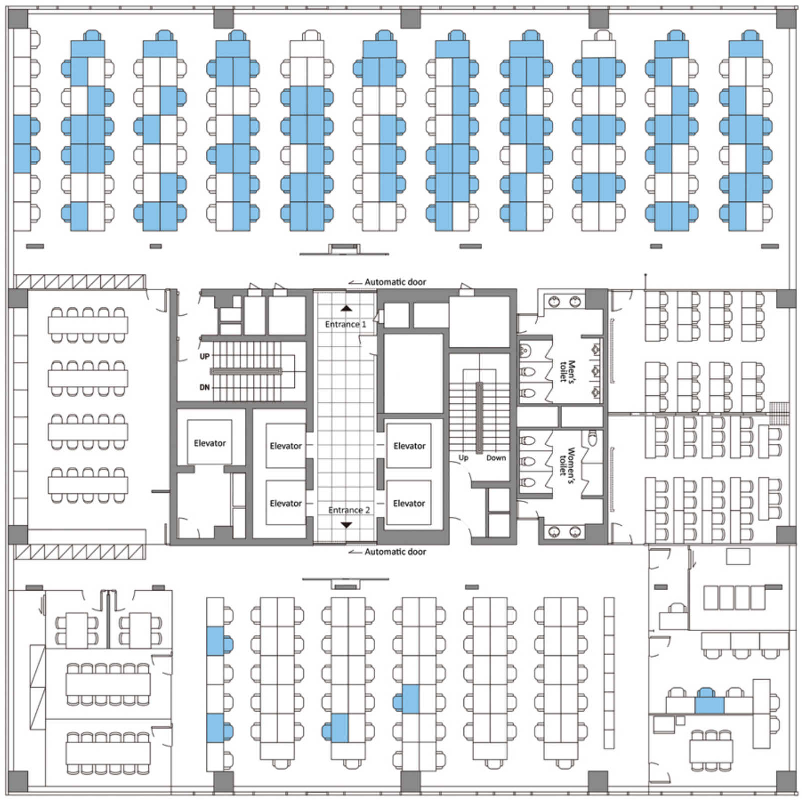

Figure 3. Korean call center floor plan and seating areas that showed confirmed cases (highlighted in blue). Source: Korean CDC.

For now, we remain concerned about the trajectory of the virus in the United States, especially in reopening states. Ex-NY and -NJ, the US case count curve has not bent, but rather just flattened. Some states are even seeing continued acceleration of new case counts, including states that are reopening already. We will be keenly watching the case data and trajectory in states like Texas and Georgia over the next two weeks, as data lags work their way through and help present a clearer view of the effects of reopening. This dynamic also appears in Brazil, the United Kingdom, and much of the Middle East, as we begin to see clearer cross-country and cross-state divergences in case curves.

Merkel-Macron proposal

Against the backdrop of fiscal cliff risk in the United States, there appears to be the beginnings of a substantive shift in European fiscal policy. German Chancellor Angela Merkel and French President Emmanuel Macron have proposed a joint European Union issuance of €500 billion of debt to finance COVID stimulus.

The fundamental problem in Europe's fiscal/monetary arrangement is that it has a common currency and central bank, but no common budget or fiscal union. There remains a lot of pushback to the joint issuance proposal from the richer surplus countries in the north, but if this proposal is able to gain traction, it would be a potential gamechanger for both macro and markets.

Surplus countries (particularly in East Asia and Northern Europe) have generated a large stock of excess savings that has trouble finding productive investment, and thus has flowed into financial assets, particularly in the US, which has the negative net international investment positions (NIIPs) to absorb these surplus flows. This is one of the reasons that the underlying backdrop in markets has continued to be large, passive, price-insensitive flows into US quality, including IG credit and megacap tech equities.

If the Merkel-Macron proposal gains traction, we expect this dynamic to begin to shift on the margin, helping to normalize the imbalance between US and ex-US risk assets, between small- and large-cap equities and credit, and between financials and tech. Additionally, this would ostensibly help support the Euro at the expense of the US Dollar, which would be a further boost to global macroeconomic dynamics and risk assets (particularly cyclicals abroad). Most importantly, it would begin the process of compressing European sovereign spreads between periphery and core countries, allowing for aggregate demand to return in some of the weaker European countries.

We are focused on this battle between the political football headwinds to renewed US fiscal stimulus on one hand, and the encouraging signs regarding European common fiscal issuance on the other. We wouldn't be surprised if political headwinds regarding more US stimulus ignited the next wave of market volatility, nor would we be surprised if visible traction on the Merkel-Macro proposal help ignite a more durable and broader rally in risk assets around the world later on.