Private Bank

CIO Strategy Bulletin

March 22, 2020

Catching the COVID-19 Knife: What It Will Take

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Introduction

With California, New York State, Illinois and New Jersey issuing “shelter in place” orders as of March 22, 2020, we are entering the “America is Italy” phase of the “Virus Crisis”. About 25% of the US workforce has been sent home. The practical realities of the health crisis are rapidly coming to life.

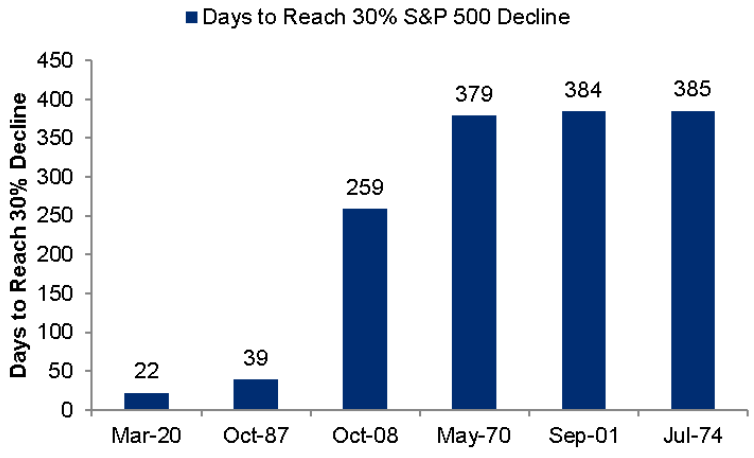
According to Columbia University researchers, “New York, Seattle, Boston and parts of California already have such large outbreaks that they will probably see significant growth even after taking extraordinary measures over the past week. Even if the transmission rate is cut in half, some 650,000 people will become infected in the next two months across the US” (New York Times, March 20, 2020). As more people get ill, the number of hospital and ER visits is beginning to strain systems. And sooner than later, whether we like it or not, there will be instances where hospitals will run out of supplies. We are likely to see TV scenes that will remind us of movies we thought were sensational. But this is real. Whether America is ready or not, the war that is this virus is here.

The Bridge from Here to There

The health and social impacts of COVID-19 are being documented extensively. But equally critical is the issue of **WHAT IT WILL TAKE** to get us from “here to there” economically. Citi Private Bank believes that with the right steps, America and the world can come out of the Virus Crisis with resiliency and growth, provided the right steps are taken right now.

Warning bells are ringing loudly. Equity markets have fallen 30% in 22 days, the fastest drawdown in the modern era. The swiftness of this selloff has reflected the remarkable speed with which the global economy is grinding to a halt as virus containment measures severely curtail our lives and our expenditures.

Figure 1: Number of days to reach 30% S&P 500 decline



Source: Haver Analytics through March 22, 2020.
Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

The strategy of "Flattening the Curve" to diminish the peak impact of the virus on health care providers and systems has the negative consequence of lengthening and broadening the shutdown of businesses. US and some other developed governments have yet to provide the unwavering support in sufficient size that would prevent a downward spiral of job losses and curtailed spending. Without greater certainty as to whether businesses will have sufficient capital to reopen and re-employ their workers, the downturn will worsen in an accelerating fashion. The same is true for millions of individuals who may not be able to pay rent, mortgage or other credit payments. For the world to come out of the health crisis rapidly and with an ability to regain its economic health, a strategy needs to be written and implemented in very short order.

The Federal Reserve has largely done its part. The Fed is backing numerous domestic lending programs such as a money market mutual fund liquidity facility and commercial paper funding facility. The Central Bank's balance sheet should ideally expand faster than it did in the wake of Lehman's failure in 2008 resulting in a massive support for liquidity and credit over the coming weeks.

WHAT IT WILL TAKE is decisive action of unquestionable magnitude on the part of the US Federal Government on the fiscal side of the ledger. To give you a sense of what this will require, have a look at the UK Government's announcement on 3/20/2020. Their goal is to prevent mass unemployment – (yes, you read that right).

> *"The government will pay 80% of gross wages in the private sector, up to £2,500 a month. Those not working and who would otherwise have been laid off will be covered by these grants from HM Revenue and Customs (HMRC). These will be backdated to March and the scheme will last three months at least."*

Governments all across Europe are doing the same thing and quickly. By doing so, they are also more likely to see people be more compliant with their own "stay at home" orders.

The Assumptions

At the core of **WHAT WILL IT TAKE** is a calculation of the amount of money the US Government would need to spend to get the US economy past the virus with minimal long-term damage. It is about what programs are needed, what cooperation is required between the Federal and State governments is required and the need to move quickly.

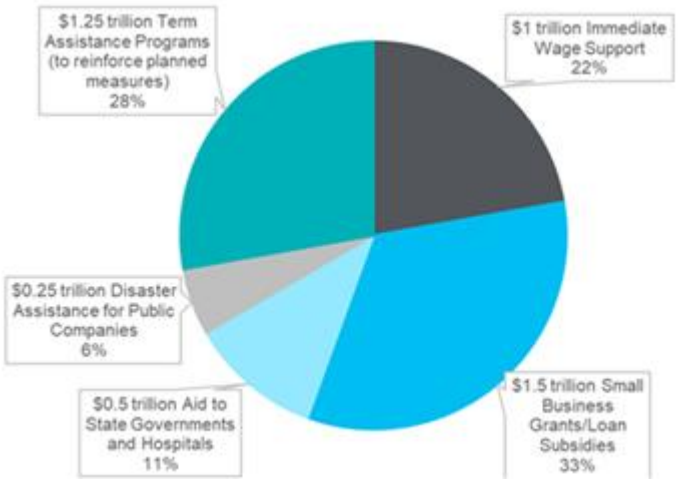
To begin, recognize that this is an unprecedented economic event. Never before have broad sectors of the American economy been "switched off" and never before have so many people been sent home for safety reasons. In wartime, the economy shifts from one type of manufacturing production to another. But in this war, doing less and making less to

create social distancing is the solution. And so, we are going to use estimates to define the parameters of these events that are bound to be inaccurate to one degree or another.

Here is how we are approaching our assessment of the situation to define **WHAT IT WILL TAKE.**

- We are assuming that the biggest wave of the virus and response will be in place for 120 days. This is a period in which epidemiologists expect the bulk of the exposure to the virus will run its course and therefore the period in which governments must act to offset disruptions.
- We are assuming that the total number of people unemployed or temporarily furloughed in the US will reach 25% of the working population for 90 days. (The hospitality and food services industry alone employs 10% of the US and many other industries are impacted).
- We are assuming that the government takes steps to "fill in" 75% of the salaries that people were earning before the shutdown up to a limit of $1100 per week, the national average weekly wage according to official data. Equally important are steps to keep operating employers paying wages wherever possible.
- We are assuming that there will be an aggregate $1.5 trillion in small and medium sized business lending or grants, as these are the firms most impacted by the lockdowns. Grants should be conditional on re-employment, over time, of employees returning to work.
- We are assuming that the Federal Government will provide expensive bailouts to certain industries, essential to the functioning of the US economy.
- We are assuming that the Federal government will subsidize private and public hospitals and provide large payments to states who see unemployment insurance and other buffers eroded.
- We are assuming that all of this happens over the next 30 days and that the policies will be retroactive to 3/15/2020. This is to limit a spiral of small business and individual defaults from having "secondary" negative consequences into the future.

Figure 2: Where the US Would Commit $4.5 Trillion

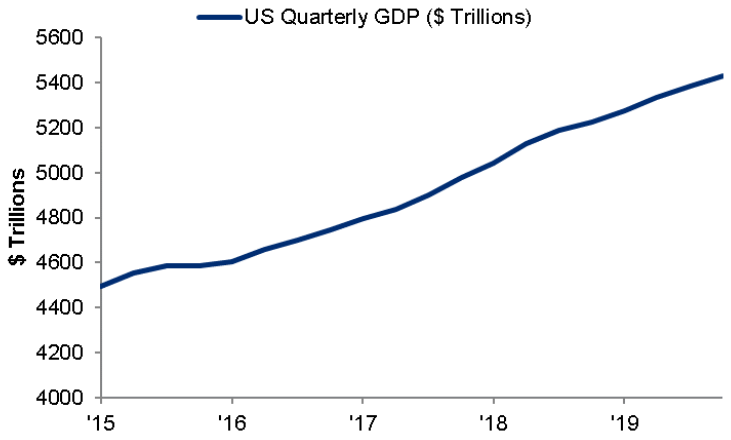


Source: Citi Private Bank – Office of the Chief Investment Strategist, March 2020.

It Will Take $4.5 Trillion

Assuming all of this, we believe the government should be willing to spend $4.5 trillion over 3-4 months. This is overwhelming force, but it provides firepower for a longer fight, if needed.

Figure 3: US Quarterly GDP



Source: Haver Analytics as of March 22 2020.

Can America Afford $4.5 trillion?

US borrowing costs average below 1.0% across the yield curve. But this is a bit beside the point. The Federal Reserve is a monopoly provider of money. A $4.5 trillion price tag is little different from the increase in its reserve base during the 2008/2009 crisis. What is being referred to as “helicopter money” would replace missing demand in the economy, not augment an already healthy economy stoking inflation.

If US leaders decide this must be borrowed and repaid instead of taken from the Fed, the US debt/GDP ratio would rise from about 100% of a single year’s GDP to about 125%. Debt servicing costs in the long-run would rise, but modestly.

If, like in war time, the US and other governments act with overwhelming force, the period of a depressed economy would not last long after the virus passes. The initial loss in the economy would be temporary and the recovery period swift. We could easily see less than $4.5 trillion actually spent.

The failure to act would create a cascade of damage. This would leave a wrenching multi-year period of unusually low tax revenues that would multiply the cost of intervention. Millions who lost their jobs would not get them back. And in a long lasting slump, many will simply be gone forever and the economy will rebound much more slowly from a deeper initial slump.

The Offer on the Table is Too Small

On March 20, 2020, Senate Majority Leader Mitch McConnell unveiled a “phase three” stimulus plan that includes direct payments to taxpayers starting at $1,200 for individuals and $2,400 for couples up to $99k in income, $58 billion for the airline industry, $150 billion for impacted industries, and $300 billion in loan guarantees for small businesses.

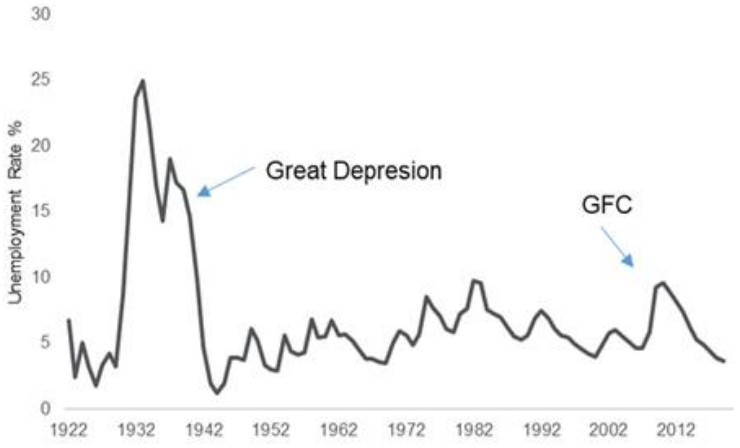
This is not yet sufficient, in our view, to overcome the tsunami that is COVID-19 and a shuttered US manufacturing base.

The Value of Resolve to Financial Markets

There are no modern historical examples of the US economy so desperately in need of intervention for reasons exogenous to business and finance itself. However, the two cases of the Global Financial Crisis and the Great Depression provide contrasts in policy and economic outcomes. In both cases, excesses in finance and the economy itself necessitated wrenching adjustments. However, the massive steps taken to pull the US economy back from the brink in GFC resulting in far better outcomes than in the Great Depression (see figure 3). In the Great Depression, policymakers initially denied a role for government intervention in the economy. As much as we admire the power of

markets to generate the best outcomes for economies, there are clear cases when private market forces alone are unable to match the power of collective action. This is one of those times.

Figure 4: US unemployment rate



Source: Haver Analytics, March 2020.

You'll Know If It Work By How The Market Reacts

The ultimate equity market recovery will likely mirror the underlying economic recovery following this crisis, with the markets leading economic data. If fiscal policy is able to prevent a downward spiral of credit issues and rising unemployment, global consumption is likely to bounce back sharply, with markets anticipating that rebound within a few months. That is the best case. A commitment to spend $4.5 trillion is what it will take to get there based on our assumptions.