Financial Markets Commentary – 4/2/2020

by Robert G. Kahl, CFA, CPA, MBA

Dealing with COVID-19

Governments and health professionals around the world are learning to deal with COVID-19 in rapid fashion. Some of the original antibody test kits that were sent from Chinese suppliers to Europe were found to be inaccurate and unable to detect COVID-19. The availability of accurate test kits is now improving. China now requires certification of test kits, protective clothing, masks, and infrared thermometers before they are shipped. Several US companies have announced test kits that can identify COVID-19 antibodies within 10 minutes. Accurate testing with a quick turnaround is essential to identify, isolate, and treat people who have the virus.

Normally, drugs are put through a series of clinical trials that require years prior to approval by the FDA. Given the nature of the pandemic, however, the FDA is keen to approve drugs that work. The FDA has issued an emergency use authorization for chloroquine and hydroxychloroquine, antimalarial drugs that had positive results based on a small sample size. Remdesivir, a promising antiviral drug developed by Gilead, is being used in seven clinical trials and data from the studies should be available in April. Three other drugs (Kevzara, Actemra, and Kaletra) developed by different drug companies are currently in human clinical trials. Two other drugs from Regeneron and Vir Biotechnology should be in human clinical trials by this summer.

According to data from John Hopkins University, as of April 1, there were 931,991 cases worldwide and 46,680 deaths. In December 2019, the world was unprepared for the current pandemic. But we learn quickly when we must. The availability of fast, accurate testing and effective drugs should flatten the incidence curve for the disease quickly.

$2 Trillion Stimulus Package

On March 27, the President signed into law the Coronavirus Aid, Relief and Economic Security (CARES) Act, a $2 trillion economic stimulus package. In addition to the CARES Act, President Trump is calling for an additional $2 trillion infrastructure spending package.

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The federal government is dropping any pretense of fiscal responsibility. As of April 1, the total federal debt outstanding was $23.7 trillion. In fiscal year 2019, the US Government had total tax revenue of $3.46 trillion and total federal spending of $4.45 trillion. The budget deficit for the current fiscal year will certainly be a record and will likely approach $3 trillion.

The $2 trillion CARES Act spending authorization was divided as follows:

1) Individuals $603.7 billion
    a) $300B cash payments
    b) $260B extra unemployment payments
    c) $43.7B student loans, other
2) Large Corporations $500 billion
    a) $425B loans for corporations
    b) $58B airline industry
    c) $17B "Required for national security"
3) Small Businesses $377 billion
    a) $350B new loans
    b) $17B relief for existing loans
    c) $10B grants
4) State and Local Governments $339.8 billion
    a) $274B COVID-19 response
    b) $14B higher education
    c) $13B K-12 programs
    d) $5.3B family programs
    e) $5B block grants
    f) $28.5B state and local-other
5) Public Services $179.5 billion
    a) $100B hospitals
    b) $20B veterans' health care
    c) $16B stockpiled equipment
    d) $15.5B SNAP – Supplemental Nutrition Assistance Program
    e) $11B drug access
    f) $8.8B child nutrition
    g) $4.3B CDC programs and response
    h) $1.3B community health centers

i) $0.45B food banks
j) $0.08B FDA prioritization of drugs
k) $2.05B public services-other

The US Treasury will issue more debt to finance the expenditures and the Federal Reserve stands ready to buy it. The increase in the money supply created by this "monetization of debt" will have an inflationary impact as it is used to purchase goods and services. To some extent this will be offset by the deflationary impact of credit contraction in certain segments of the debt market.

The impact on the economy of the business shutdowns related to the corona virus are dramatic. Last week, 3.3 million people in the US filed initial unemployment claims. This week, 6.6 million people filed initial unemployment claims.

Goldman Sachs now expects the unemployment rate to reach a peak of 15% during the second quarter before improving. Economic forecasts vary widely for the remainder of the year. Goldman Sachs has a more dire outlook than most and expects a decline of 8.5% (34% annualized) in 2nd quarter US GDP with a full calendar year decline of 6.2%.

S&P Global has a more optimistic outlook with unemployment peaking at 13% in May. For US GDP, S&P forecasts declines of 12% and 1.3% for the second quarter and full year, respectively. S&P indicated that the risk to their forecasts are on the downside and outcomes are highly uncertain.

The US Treasury and Federal Reserve are All In!

Between March 11 and April 1, the Federal Reserve (Fed) has increased its assets by $1.5 trillion. The Fed has purchased US Treasury securities, agency mortgage-backed securities and has been active in the repo (repurchase agreement) market. Given the looming increase in the issuance of US Treasury debt to finance the expanding budget deficit, the Fed will most likely continue to be the primary buyer of US Treasury debt and continue to expand its balance sheet at a rapid pace.

The original purpose of the US Treasury's Exchange Stabilization Fund (ESF) was to give the United States adequate financial resources to stabilize the value of the dollar by buying and selling foreign currencies and gold. The ESF had assets of $22.7 billion as of February 2020.

As part of the COVID-19 stimulus package (H.R. 748), Congress appropriated $500 billion to the US Treasury's Exchange Stabilization Fund (ESF) to support loans, loan guarantees, and investments for businesses affected by COVID-19. In addition, the legislation would temporarily permit the use of the ESF to guarantee money market funds, as occurred in the 2008 financial crisis.

The ESF is also authorized to make equity investments in five special purpose vehicles (SPV) and be in a "first loss" position. The ESF has pledged $10 billion in ESF assets to back the five new SPVs created by the Fed ($50 billion in total – for starters) for the following purposes:

- CPFF (Commercial Paper Funding Facility) – to purchase commercial paper from issuers.
- PMCCF (Primary Market Corporate Credit Facility) – to purchase corporate bonds from issuers.
- TALF (Term Asset-Backed Securities Loan Facility) – to fund a backstop for asset-backed securities.
- SMCCF (Secondary Market Corporate Credit Facility) – to buy corporate bonds and bond ETFs in the secondary market.
- MSBLP (Main Street Business Lending Program) – to lend to eligible small and medium-size businesses, complementing efforts by the Small Business Administration.

US Government tax receipts as a percentage of GDP were 16.2% in 2019. The ability of the US Government to effectively bail out everyone with a currency that maintains its value is limited. The ability of the US Government to issue debt that is purchased by the Federal Reserve, creating more fiat currency and "monetizing the debt," is unlimited. The debt ceiling set by Congress, which was once considered to be a limiting factor, is routinely raised.

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Moving Forward

The financial markets are likely to remain erratic for a while. Some of the price action appears unrelated to the economic news or specific company news. Some good values are now available in the financial markets. Kyle Bass, Chief Investment Officer of Hayman Capital Management, gave an interview to CNBC on March 18. He said, "You can actually be a value buyer once again. I forgot what they looked like in the last decade."

As I mentioned in my e-mail to clients on March 25, investment-grade fixed income has served us well in the past, but low interest rates and higher inflation will make this asset class less appealing in the future. In the high yield debt sector, I believe that we'll see many credit downgrades and the yields still do not justify the risk.

Precious metals continue to offer a good currency alternative. In response to COVID-19, gold and silver mines in South Africa, Mexico, and Peru have been shut down. Gold refineries in Switzerland have also been shut down temporarily. In the meantime, the COMEX is experiencing delivery problems and retail investors are willing to pay large premiums to the quoted spot prices for one-ounce coins or bars, if they can find them. Investment demand has picked up considerably during March and precious metals still represent a very small portion, if any, of most investment portfolios.

If you have any questions or comments, please contact me.

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