April 12, 2020

HB Perspective on Fiscal Stimulus and Deficits

Welcome. This is Ross Bramwell, a principal in the Investments Department at Homrich Berg. Of course, first and foremost, we hope you and your family are safe and well during this health crisis. In our continued effort to communicate through these challenging health and economic times, I'll take you through today's commentary and discuss the fiscal response of our government and its potential impact on the deficit and economy going forward. As headlines are changing almost daily, this is our current outlook on these topics as of April 12, 2020.

The stock market began the year priced for improving growth and earnings. Then COVID-19 became the black swan event that ended the longest bull market in history. Investors were forced to reprice stocks due to supply chain disruptions, community spread of the virus, and an abrupt shutdown for most of the global economy. As a result, the S&P 500 experienced its swiftest decline in history. The eventual recovery will likely be dependent on several factors including medical, monetary, and fiscal policy. In other words: if and when the virus is contained, if businesses can bridge the gap, and the speed and effectiveness of stimulus. We already saw 10 million unemployed claims in March. The first week of April had an additional 6.6 million unemployment claims. This trend will probably continue for the next few weeks. The U.S. consumer was a main driver of the longest expansion in history, but these almost depression-like unemployment numbers are going have a significant economic impact in the short term and long term.

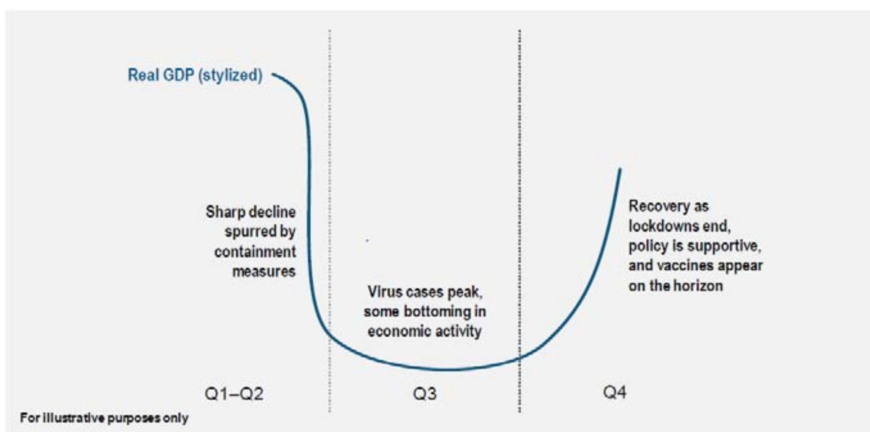
INITIAL UNEMPLOYMENT CLAIMS (MILLIONS) 2020 RECESSION	
WEEK ENDED MARCH 21	3.31
WEEK ENDED MARCH 28	6.65
	9.96

PRIOR RECESSIONS*		
		NUMBER OF WEEKS TO REACH 9.96 MILLION
Dec-69	Nov-70	36
Nov-73	Mar-75	33
Jan-80	Jul-80	20
Jul-81	Nov-82	21
Jul-90	Mar-91	24
Mar-01	Nov-01	25
Dec-07	Jun-09	27
7-RECESSION AVERAGE		**27**

*THE INITIAL CLAIMS SERIES BEGINS IN 1967.

Source: BCA Research

The U.S. economy is in the midst of maybe one of the quickest, but deepest recessions we have faced. We expect that the eventual recovery will be gradual due to high unemployment. Unlike previous recessions, which are usually created by economic or financial bubbles, interest rate spikes, or oil price spikes, the trigger of this recession is a non-economic factor – it's a health shock with the resulting first-ever government mandated recession. It was a necessary, temporary, partial shutdown of the economy to help prevent an even larger health crisis. Given the massive size of stimulus and support from the Fed and Congress, we expect the global economy to transition from severe short-term pain to a gradual recovery over the year or even 18 months once the spread is under control and restrictions begin to be lifted. We believe the restrictions will be lifted gradually and at different speeds.

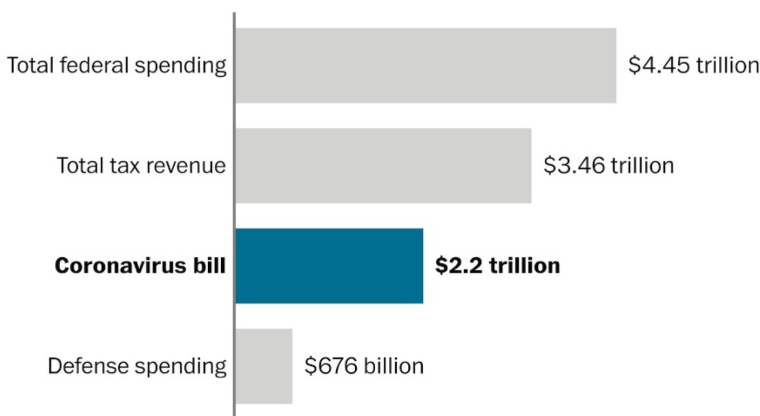


It is unlikely that we can experience a 'V' recovery, but the question of a 'U' shape recovery as shown above, and how long the bottom of the 'U' will last, will also be based on the same health, monetary, and fiscal responses that we've mentioned.

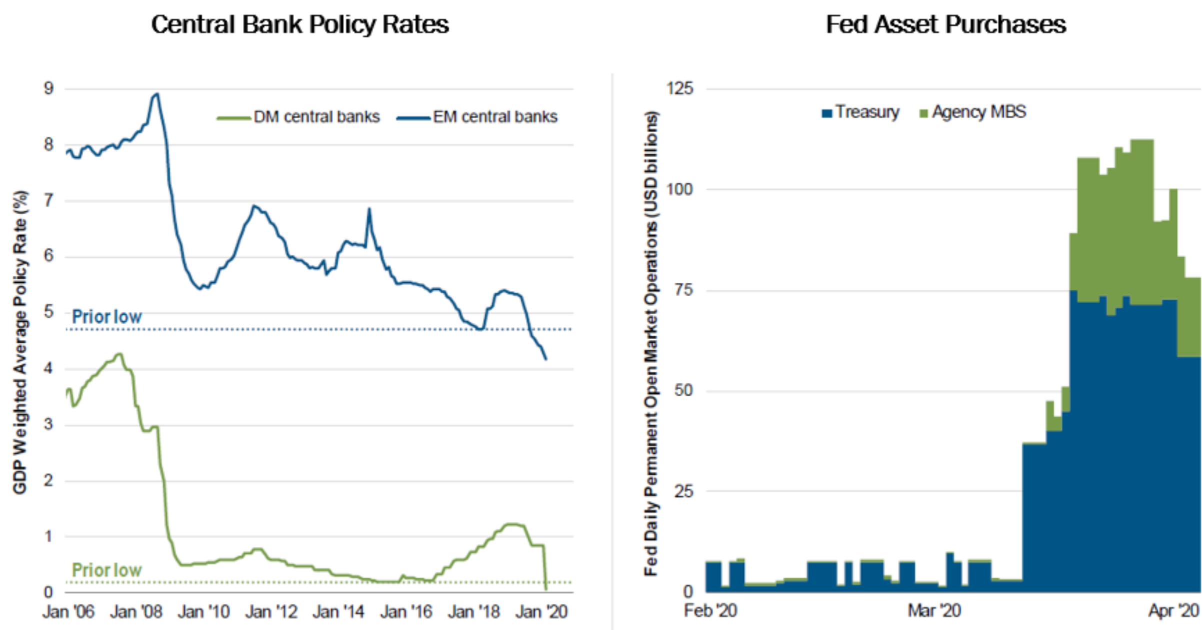
Regardless of the speed of recovery there will be long-term impacts. Some potential effects include:

- Globalization may be dialed back as firms may try to reduce the complexity and risk of global supply chains. Countries may feel obligated to limit trade, travel, and migration. Companies, sectors, and countries that are highly dependent on trade and travel may see a permanent shift in their business models.
- Increased private and public debt could challenge central-banks and also keep interest rates lower for longer to finance deeper deficits.
- Consumer spending habits may change. There may be a shift in how people save their money, as unemployment and debt could put pressure on households. That could mean less of an appetite for risky investments. Consumers may pay down mortgages faster. We may see a different investment landscape once the economy begins to recover.

In response to the recession, the third coronavirus bill was dramatic as you compare it to total spending, annual revenues, and defense spending. The fiscal stimulus is trying to bridge the economic gap until the economy can reopen. The $2.2 trillion bill targeted over $1 trillion for individuals, small business, and larger companies. Now that we know what is in the recently signed bill we can certainly understand the motivation for the stimulus programs, but there are concerns about what the long-run consequences will be.



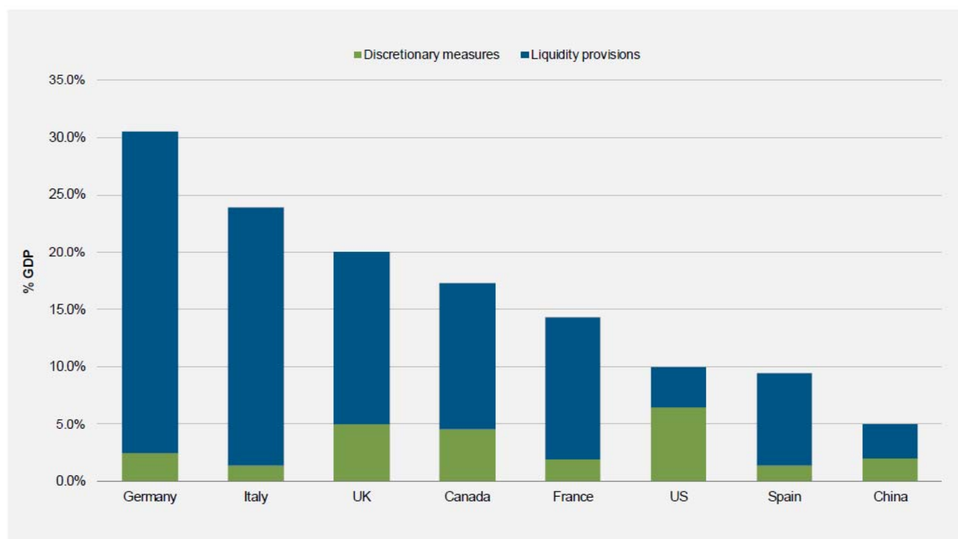
Central Banks were the first to react as the economic crisis unfolded. Central banks have cut policy rates to their effective lower bounds and/or increased broad quantitative easing and asset purchase programs with unlimited commitment in the US, and at least €750bn in the Eurozone and £200bn in the UK. The goal is to keep financial systems liquid, intact, and able to extend credit both through the crisis and also after the recovery begins.



As of 3 April 2020
Past performance is not a guarantee or a reliable indicator of future results. Left chart: DM includes Australia, Euro Area, Canada, Japan, Sweden, Switzerland, United Kingdom, United States. EM includes Brazil, Chile, China, Colombia, India, Indonesia, South Korea, Malaysia, Mexico, Peru, Poland, Russia, Singapore, South Africa, Taiwan, Thailand and Turkey.
Source: PIMCO, Haver, Bloomberg

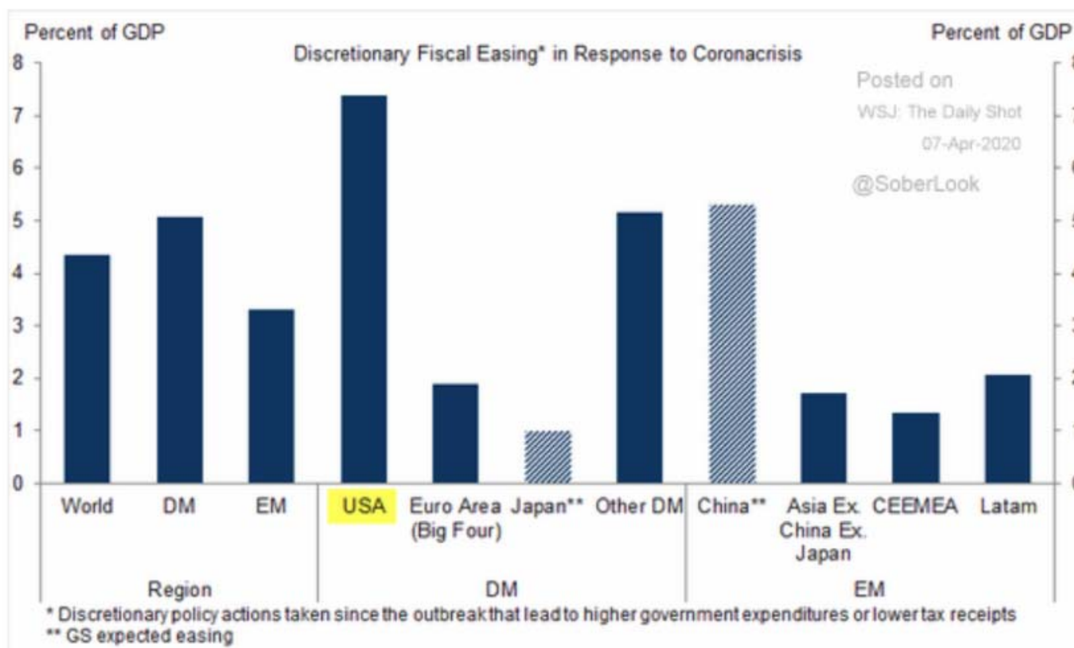
Below we have a chart that shows by country the fiscal/stimulus responses in green and the monetary/central bank responses in blue. Government responses are the largest of the post-war era. In the U.S., fiscal spending in response may exceed 10% of GDP.

In the U.S., the Fed cut interest rates by a total of 150 basis points in two emergency meetings, taking the federal funds rate to 0-0.25%, along with $700 billion in asset purchases, or quantitative easing (QE). The Fed followed with other actions including unlimited and open-ended QE purchases of corporate and municipal government bonds; trillions of dollars in repurchase agreements in hopes to flood the markets with cash; swap lines with other major central banks to provide dollar funding; programs to support money market funds; various easing of bank capital buffers; and funding to help credit flow in asset-backed securities markets. The Fed said its ability to provide support was limitless and it tried to prove it early.



The European Central Bank added 120 billion euros to its existing asset-purchase program of 20 billion a month. The ECB added another 750 billion euros in QE, taking the total to about 1.1 trillion euros this year. It also eliminated a cap on how many bonds it can buy from any single euro zone country and began to buy bonds from Greece. The ECB also cut the interest rate on its cheap loans to banks and provided additional bridge bank funding and relaxed capital rules.

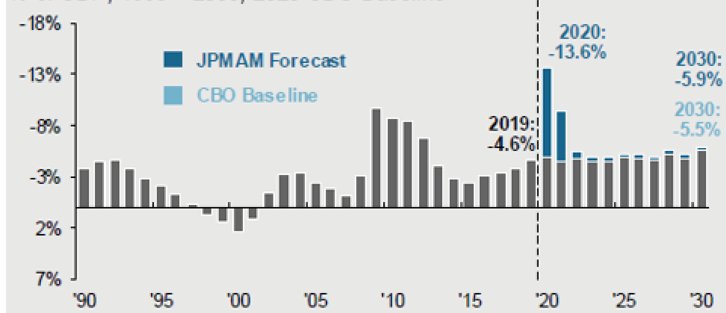
In the chart below, we look at specifically the fiscal stimulus provided by country. Let's now discuss some of the potential short term and potential long term effects of additional debt. One thought is that financial markets should be able to absorb this new wave of debt, especially because central banks have committed to buying huge amounts of government bonds as part of their own stimulus efforts.

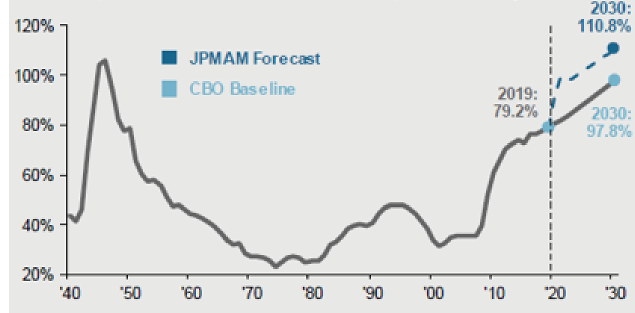


One question we often get is about potential inflation. However, most economists aren't worried about this in the short term. The prospect of rising inflation created by stimulus, is not much of a concern because consumer demand is likely to remain subdued during the recession, even when lockdowns are eased or lifted.

But once the crisis passes, the accumulated debt will remain on government balance sheets. The more debt a country has, the more it has to spend to service that debt. Low interest rates have helped the U.S. government to keep its interest down, but rates could rise in the future. Countries that want to reduce their debt levels will likely have to do so over decades. In the U.S, debt levels came down quickly after World War II because the economy was growing rapidly. A growing workforce also helped.

The children born during those boom times are now growing older and demographics are working against the U.S., as well as other countries. The coronavirus could also permanently change or shift some consumer behaviors, suggesting that modest growth could be a challenge. Countries with similar levels of debt to the United States but more limited growth prospects are facing an even greater challenge.





Source: CBO, J.P. Morgan Asset Management; (Top and bottom right) BEA, Treasury Department. 2020 Federal Budget is based on the Congressional Budget Office (CBO) March 2020 Baseline Budget Forecast. CBO Baseline economic assumptions are based on the Congressional Budget Office (CBO) January 2020 Update to Economic Outlook. Other spending includes, but is not limited to, health insurance subsidies, income security and federal civilian and military retirement. Note: Years shown are fiscal years (Oct. 1 through Sep. 30). Guide to the Markets – U.S. Data are as of March 31, 2020.

It's true that very large deficits are coming due to the pandemic. However, we have to consider what would happen if Congress did nothing. Overall, we believe the stimulus package to bridge any gap is more likely to leave the U.S. in a better overall position than the alternative in which the government is more frugal, but fails to prevent the widespread collapse of businesses or fails to help workers stay employed if possible.

Economists try not to focus solely on the absolute level of the debt, but also on the interest costs to service the debt relative to the size of the economy. A prolonged recession could be even worse for the debt picture than some extra spending in the short term. Given where interest rates are and demand for U.S. debt, the government should be able to borrow on favorable terms with global central banks expanding bond-buying programs.

Finally, the current stimulus is meant to last only as long as needed to get the economy back on the path to recovery. It should just be a one-time increase during the pandemic. Many expect the deficit created to be 10-13% of U.S. GDP. Those numbers would exceed the previous post-World War II record for the deficit, which was in 2009, when it was 9.8% of GDP. The exact numbers are still unknown. But as Congress is already discussing a fourth bill, more stimulus is most likely coming over the next couple of months and will be required to support the economy.

And there are the long-term issues, but unlike a private borrower the government does not have to pay down its debt. The government has a tremendous capacity, as we know, to kick-the-can down the road. Theoretically the debt can remain on the balance sheet indefinitely, so long as the cost of interest payments is manageable, which in turn depends on economic growth. The hopeful result of the stimulus would be an economy that recovers quicker and thus a lower debt-to-GDP ratio than if the government had not stepped in to provide support.

Looking at history, there was the $800 billion fiscal stimulus the Obama administration enacted in early 2009. However, the budget deficit peaked that year and declined over subsequent years as the economy recovered.

The Fed may one day need to raise interest rates and sell off its purchases to combat inflation. But that would most likely occur at a time when the economy had improved and was seeing higher inflation levels than have been realized over the last decade. Remember, the Fed has been unable to consistently hit its inflation target since the last recession. Currently, deflation is more likely to be a problem in the short term. The price of oil has plunged this year, and bond prices imply that inflation will average only about 1% annually over the coming decade. For all those reasons, although we may dislike higher deficits, the stimulus is probably the more desired alternative than no action that could have led to a worse scenario. We will have to face consequences still down the road, but in the short term it was probably required, and most likely we will need more stimulus to bridge the economic gap as we expect unemployment numbers to increase.

Thank you for your time. If you have further questions, please contact a member of your service team.

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