Brian McCarthy
Chief Strategist
(o) 203-614-8600
brian.mccarthy@macrolens.com

MACROLENS
Markets in High Resolution

CaronaCrash Roadmap II and Weekend Links

Well the S&P500 went through my 2600 target like a hot knife through butter. That target was predicated on the likelihood of an economic sudden stop but, critically, not a deterioration into a self-reinforcing liquidity crisis beyond the ability of central bankers to address.

The sudden stop is now "in the market." They cancelled March Madness. There isn't a trader on Wall Street who doesn't viscerally understand that a sudden stop is happening.

On Monday I wrote it's Still Just a Virus Trade, noting that markets were working out a guesstimate of the capitalized value of disruption losses, and that "we're approaching bottom-fishing time **so long as the risk-off / Dollar off correlation remains** intact."

Of course, that correlation did not remain intact, but instead began to break down mid-week, foreshadowing Thursday's wipeout (replete with the actual stocking up on canned goods and ammunition by many market participants).

USD strength amidst a sharp risk-off (note that gold collapsed as well) is the surest sign that the Fed is at risk of falling behind the curve in supplying liquidity in the face of escalating precautionary demand. Fear-based liquidity demand, if not satisfied, generates forced selling of assets, exacerbating fear-based liquidity demand. No one wants that.

As with the emergency rate cut on March 4th, the Fed's offer of essentially unlimited repo liquidity yesterday was a necessary-but-not-sufficient action. **It's nice to know they're THERE**, addressing the rapid deterioration in market liquidity in key fixed income markets - action that is essential to their role in the system.

Brian McCarthy
Chief Strategist
(o) 203-614-8600
brian.mccarthy@macrolens.com

Clearly, an economic system facing a month-long shutdown will have an extreme need for liquidity. The Fed must meet this demand by whatever means necessary. If that means infinite repos or re-starting QE or temporarily scrapping restrictive bank liquidity requirements, I assume they'll do what needs to be done. This much they've surely learned.

Bridge Liquidity vs. Bridge Solvency

But unlike 2008, which was in essence a liquidity-creation problem stemming from the deterioration in counterparty confidence, the present situation threatens something ever more pernicious: a genuine credit crisis. By that I mean a crisis rooted ultimately in credit quality, not liquidity. (2008 started with a credit problem, but the "crisis" began with the resulting liquidity breakdown).

The virus hits a corporate sector that is highly levered. I am not a corporate-leverage doomsayer. Two months ago I would have suggested that gearing up via buybacks in a low-volatility economy, at generationally low interest rates, was a good idea (within reason). Who knew?!?

The problem with high leverage is that it leaves one vulnerable to "crapping out" in the face of an unexpected disturbance. And now we face a big disturbance.

If we all knew the sudden stop would last two weeks, the answer would be pretty simple: bridge credit. An entity would have to be crazily levered not to be able to sustain additional credit equivalent to two weeks of revenue. But what if its two months? What if its six months?

At a longer duration of disruption, bridge credit will start to be viewed by lenders as untenable. At some point, making up for lost revenue with debt simply doesn't work. Who would to lend to a levered hotel chain if they knew their occupancy rate would run at 20% for 9 months, without requiring some form of equity write-down and restructuring? An extended disruption will necessitate a combination of liquidation, restructuring, and government subsidy in some form.

We better hope for a brief disruption, because **the scope for government policy to solve the "bridge solvency" problem is extremely limited**. There are two big hurdles:

- **There is no political appetite for tax cuts**. Tax cuts provide a future benefit that can be capitalized to make an entity more "bridge-creditworthy." If two entities have similar economics, you're more comfortable lending to the one with the 10% tax rate vs. the one with the 30% tax rate, right?

Brian McCarthy
Chief Strategist
(o) 203-614-8600
brian.mccarthy@macrolens.com

- A subsidy program is impossible to coordinate. Which entity gets what size check? Who decides? Our system of government is not designed for this sort of thing.

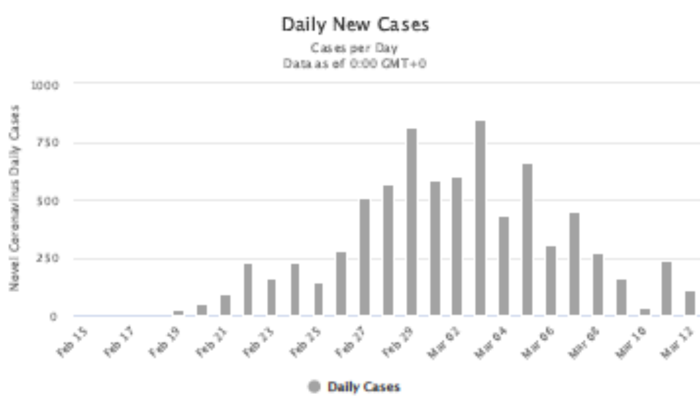
(The "fiscal package" emanating from the House - comprised of a new paid sick leave mandate, free coronavirus testing and expanded unemployment benefits - does absolutely nothing to address this "bridge solvency" problem. It's little more than a band-aid.)

So that's the bad news: if widescale economic disruption extends more than a handful of weeks, there seems no political path to a viable policy response which might avoid a cascade of small business failures and corporate defaults.

The good news is that a disruption of longer than a handful of weeks appears unlikely.

We know that aggressive "social distancing" works:

Daily New Cases in South Korea



And we know that the U.S. and Europe have entered a period of aggressive social distancing. Again, this is now "in the market."

The question now is whether we will all be able to safely emerge from our bunkers in 3-4 weeks without a series of renewed outbreaks.

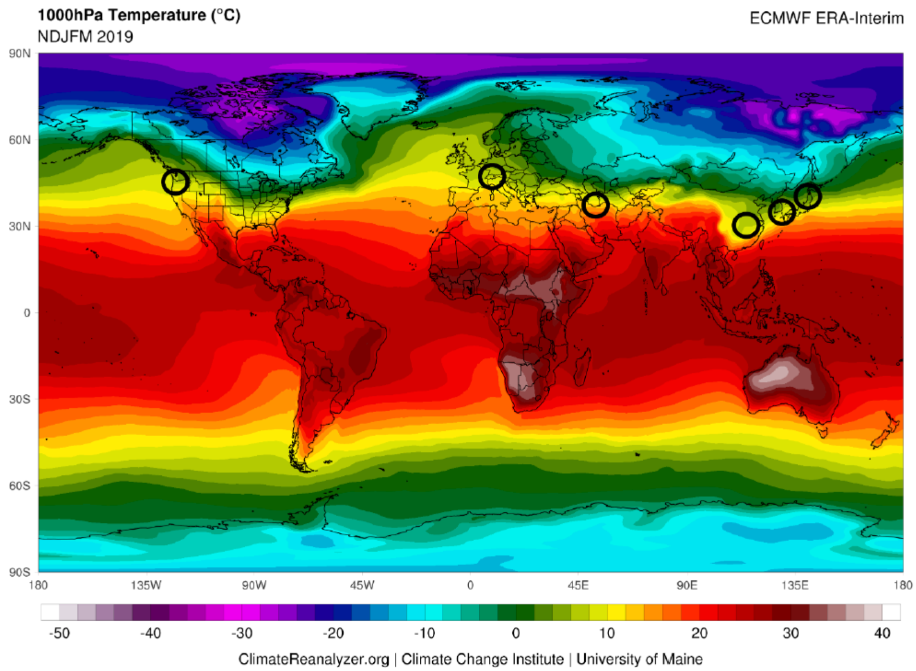
(On this score, I take little solace from official Chinese data. Each day, the Chinese announce a handful of "imported infections" caught by airport screening procedures. It's simply impossible that their interdiction rate is 100%, so presumably there are many more virus carries entering the country undiscovered. Yet day after day they report a negligible number of locally-borne virus cases. It's simply not credible.)

Brian McCarthy
Chief Strategist
(o) 203-614-8600
brian.mccarthy@macrolens.com

More optimistic is the **evidence that the virus will exhibit a seasonality** similar to the common cold or flu. Of course, we have no direct evidence as to how the coronavirus will behave in the northern hemisphere summer because it's never been circulating among humans in the summer. And from a public health perspective, we can't simply assume the virus will dissipate and not take remedial action now because being wrong would mean catastrophe.

But market participants are facing a bet that needs to be made with incomplete information. Aside from the array of respiratory diseases that display seasonality, the small sample of empirical evidence we do have is reasonably compelling. This paper from the University of Maryland is brief and readable and makes a clear point: **the locus points of community spread are occurring along and East-West plane**. The virus does not seem to be travelling well in a North-South direction.

The map denotes that all the SARS-CoV-2 virus "*has established significant community spread in cities and regions only along a narrow east west distribution roughly along the 30-50 N" corridor at consistently similar weather patterns (5-11OC and 47-79% humidity).*"



This is not to say that the virus will disappear completely (or that places like Australia might not have a problem in a few months). But if social distancing "flattens the curve" and April brings warm weather that suppresses the contagion to levels of a "summer cold," then the "fiscal policy support" required to avoid a wave of failures beyond that which is already priced in may be doable.

Brian McCarthy
Chief Strategist
(o) 203-614-8600
brian.mccarthy@macrolens.com

But **do not count on policymakers figuring out how to bridge the system through an extended disruption**.

Pray for an early spring. On to the links…

The rate of work resumption remains sluggish. Actions on the ground do not corroborate the official narrative of victory over the virus…

Shanghai tightens airport checks as imported virus infections in China jump

> *In addition to the growing risk of imported infections, China faces a challenge in trying to get migrant workers back to work by early April.*
>
> *So far, 78 million migrant workers, or* ***60% of those who left for the Lunar New Year holiday in January, have returned to work****.*
>
> *Yang Wenzhuang of the National Health Commission (NHC) said that the "risk of contagion from increased population flows and gathering is increasing ... We must not relax or lower the bar for virus control".*

From the folks at Trivium…

> *As of March 13, we estimate that:*
>
> - ***China's economy is operating at 66.3% of typical output.***
> - *Large companies are operating at 74.2% of their typical output.*
> - *SMEs are operating at 61% of their typical output.*
> - *The vast majority of Chinese businesses have at least turned the lights back on.*
> - *Achieving full capacity utilization is still hampered by workforce shortages.*

Halting China's Economy Was Hard. Restarting It Is Harder.

> ***factories in China are running at 50 to 60%t of capacity****, and other measures show even less activity in many places.*
>
> *Beijing has unleashed a series of top-down measures to get offices and factories humming again. Bankers describe almost daily phone calls from regulators, telling them*

Brian McCarthy
Chief Strategist
(o) 203-614-8600
brian.mccarthy@macrolens.com

to show leniency on debt repayments, particularly from smaller businesses. Insurers have been told to extend policies even when premiums are not paid on time.

The state-owned railway has halved a wide range of freight charges. The national education ministry has created 180,000 spaces at graduate schools next autumn for students graduating this spring with little prospect of a job. Shanghai alone says it has helped residents and businesses with more than $15 billion in loans and other credit assistance, mainly from the state-controlled banking sector.

*Those measures face formidable hurdles. **Local officials are under pressure to reduce new infections, making them nervous about allowing people to return to work**.*

***Cash-strapped families may also be reluctant to spend**. Household and corporate debts are huge after a decade of heavy lending by the state-controlled banking sector. Workers do not know whether their employers can pay them. Businesses do not know if other businesses will default on payments for goods and services.*

Any Q1 GDP forecasts with a + sign in front of it is utter fantasy…

Coronavirus: China's risky plan to revive the economy

"How is it possible", Mr Zhang added, "for the economy to achieve positive growth in the first quarter when more than 1bn people stayed at home for nearly a month?"

*According to a China Merchants Bank index that uses satellite imagery to track night-time activity, as of Monday just **under 60% of 143 major industry sites across the country had resumed operations**.*

G7 Networks, a start-up that collects GPS data from about 20% of China's cargo vehicles, has been releasing a daily tally that shows a rapid recovery in full-truck deliveries usually made by major companies, but only a gradual uptick for shared consignment shipments, which tend to be used by smaller businesses.

*Compared with early February when this data looked "extremely bleak", big deliveries to factories and construction sites have rebounded to about 60% of peak November levels. But smaller shipments are only running at about 26% "not because there are no drivers, but **because there are no orders**", says Sun Fangyuan, a G7 market director, adding that consumption had started to pick up in the past week.*

More ominously for China's cash-strapped local governments, which in 2018 raised

Brian McCarthy
Chief Strategist
(o) 203-614-8600
brian.mccarthy@macrolens.com

> *almost 40% of their total revenues from land sales, house sales across China's 30 largest cities fell more than 80% in the first three weeks of February compared with the same period last year, according to official data. This has hit developers, which have tried but largely failed to entice buyers with online deals and steep discounts. **Land sales are now running at less than a quarter of average levels**, according to China Merchants Bank.*

This is a bit garbled via Google translate, but the piece describes banks tripping over themselves to extend consumer credit but finding a **dearth of credit demand** against a backdrop of faltering property markets…

银行群呼散客来贷款，居民消费贷滑坡五千亿

> *Zhang Bin, a senior researcher at the Financial Forty Forum, is more **worried about the collapse of credit**, because credit determines how much money everyone has in the pockets of the whole society, how new purchasing power is, and how much total demand is.*
>
> *"It is necessary to pay close attention to high-frequency credit data. If the credit data is too miserable, it will also have an impact on the subsequent economic recovery." Zhang Bin said.*
>
> *Regarding the financial data for March, the above-mentioned financial researcher pointed out that **it still depends on the real estate sales situation in the future. If this is not restored, credit will decline accordingly**.*

The Chinese government is really scrambling domestically, which ultimately is what produces the diplomatic insanity of accusing the U.S. Army of originating the virus…

When Propaganda Bites Back

> *CMP reported yesterday on the firestorm that ensued online in China as news circulated that Wuhan's top official, Wang Zhonglin, said during an internal meeting that the city needed to "carry out gratitude education among the citizens of the whole city" so that they thank Xi Jinping and the Communist Party of China for the response to the coronavirus epidemic.*
>
> *Internal directives from press control officials now suggest this has been **a full-blown public opinion crisis** for the Party, and that the wound was self-inflicted. Media have been ordered not to share the original article, publish commentaries, or otherwise*

Brian McCarthy
Chief Strategist
(o) 203-614-8600
brian.mccarthy@macrolens.com

address the issue at all. The report on Wang's remarks by Wuhan's official Changjiang Daily has been withdrawn, but remains available online from certain sources.

Campaign to 'thank' Xi Jinping flatly rejected by Wuhan citizens

Why is Beijing pushing for global gratitude? The answer is simple.

The Chinese leadership is facing a governance crisis*. It is not easy to see from the outside. At first glance, it seems that China has passed the peak of the coronavirus epidemic and restored calm. But whether Beijing's response to the crisis can stand the test of time and history remains to be seen.*

U.S. – China Relations

It's not on the market's radar right now, but **U.S.-China relations have been badly damaged** by recent events…

U.S. senator calls for action on forced labor in China's Xinjiang

In a letter to Commerce Secretary Wilbur Ross, Democratic Senator Bob Menendez said recent reports indicated a wide array of U.S. companies, including Apple (AAPL.O), Kraft Heinz (KHC.O), Coca-Cola (KO.N), and the Gap (GPS.N), had sourced, or continued to source, goods from Xinjiang.

"Moreover, there are consistent reports that U.S. companies fail to undertake basic labor and human rights assessments in Xinjiang, in essence willfully ignoring the horrific conditions of forced labor in Xinjiang," Menendez, the ranking member of the Senate Committee on Foreign Relations, said in the letter.

"In failing to uphold their responsibilities to vet their supply chains, these companies may be complicit in the mass repression of Uighurs, ethnic Kazakhs, Kyrgyz, and members of other Muslim minority groups," he said.

The firms Menendez mentioned did not immediately respond to requests for comment.

Cotton is an Uber-hawk, but it's hard to see how U.S.-China relations emerge from this episode unscathed…

Brian McCarthy
Chief Strategist
(o) 203-614-8600
brian.mccarthy@macrolens.com

Tom Cotton: Coronavirus Outbreak Is 'Moment of Reckoning' Between U.S. and China

> *"We are now largely dependent on China having outsourced so much of our pharmaceutical manufacturing for basic pharmaceutical ingredients, like Tylenol or Advil," Cotton stated. "They feel empowered to threaten our people if we hurt their feelings, if we extend the travel ban. So we have to have the immediate response to the Wuhan coronavirus, but **this is a moment of reckoning in which we will have a far-reaching reevaluation of our relationship with China**."*

Tightening the entity list screws on Huawei is on hold for now…

U.S. again postpones high-level meeting on Huawei and China: sources

> *Trump administration officials have postponed for a second time a critical meeting originally set for Wednesday to discuss potential new U.S. restrictions on sales of technology to Huawei and China, people familiar with the matter said.*
>
> *The cabinet-level meeting had been set for Feb. 28 but was put off. Reuters was unable to determine when the meeting would take place.*
>
> *Among topics on the agenda for the original meeting were ways to expand U.S. authority to stop more foreign shipments of products with U.S. technology to Huawei Technologies Ltd. The possible changes are designed to address frustration by some in the administration that the company's placement on a U.S. trade blacklist in May failed to cut off supplies to the world's largest telecommunications equipment maker.*

…but this action could be a death sentence:

U.S. lawmakers seek to curb Huawei's access to U.S. banks: document

> *WASHINGTON (Reuters) - U.S. lawmakers plan to unveil a bill on Thursday that could be used to block Huawei Technologies Ltd from accessing U.S. banks for certain transactions, in a bid to thwart the Chinese telecoms giant amid frustration over the failure of prior sanctions to curb its business.*
>
> *The bill, with sponsors including top Senate Democrat Charles Schumer, Republican Senator Tom Cotton and House Republican Mike Gallagher, would ban U.S. firms from taking part in "significant" transactions with foreign companies that produce 5G telecommunications technology and engage in industrial espionage.*

Brian McCarthy
Chief Strategist
(o) 203-614-8600
brian.mccarthy@macrolens.com

Miscellaneous

This blog post provides a much more satisfying explanation that "funding currency unwind" for the strength of the Euro in the face of a severe "risk off"…

What the strong euro is telling us

> *It's become a cliché that the Japanese yen is a "safe haven currency", which does well when things are going poorly in the global economy. I've never really understood that claim. What makes Japan a safe haven? And why does the yen do well even when Japan itself is the epicenter of the problem, as with the 2011 tsunami? People have offered explanations, but they seem quite weak, very ad hoc.*
>
> *In the past, I've offered an alternative theory, that Japan's yen appreciated during times of trouble because Japan was at the zero bound. Because the BOJ could not cut rates further, a fall in global interest rates tends to raise Japan's policy rate relative to the equilibrium interest rate. This makes Japanese monetary policy tighter. In contrast, the Fed tends to cut interest rates when the equilibrium interest rate falls (albeit with a lag.)*
>
> *How would we test my theory? Suppose another big economy also hit the zero bound, an economy that could not possibly be regarded as a safe haven. Also assume that the currency in that economy appreciated strongly during a global crisis, even though the epicenter of the crisis was in that very economy.*
>
> *Of course, I'm talking about the eurozone, which is currently at the center of the global coronavirus problem*