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Markets in High Resolution

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Doves Disappoint and Weekend Links

Everyone seems to know that the Fed is going to be forced into cutting rates - except the Fed.

We've now heard from three of the leading doves, and all were disconcertingly complacent:

Clarida:

> *Fed No. 2 Richard Clarida said on Tuesday that it was "still too soon to even speculate" about the size or persistence of any effects on the U.S. outlook and that the central bank had monetary policy in a good place.*
>
> *"I think that **our monetary policy is pretty well positioned for the risks that we have seen coming**," he told reporters. "I would say that this was not on my radar screen when we made three rate cuts last year, but I certainly feel better about the positioning of policy with any type of additional risk that we might be facing."*

Evans:

> *It **may take several months** to judge the impact of the coronavirus outbreak on the U.S. economy, said Federal Reserve Bank of Chicago President Charles Evans, though policy makers are watching the situation carefully.*
>
> *"I think it would be premature, until we have more data and have an idea of what the forecast is, to think about monetary policy action," Evans told reporters Thursday after an event in Mexico City.*
>
> *"But we're monitoring it very closely, and if we see something that does require adjustment, I'm confident we'll give that all the consideration it needs."*
>
> *Evans told reporters the Fed has the capacity to respond if necessary, adding that it would take a few months to have an idea of what the appropriate response would be. "If circumstances required some additional accommodation, we have that capacity. The first way I'm going to think about this is whether or not lending behavior is adversely influenced," Evans said. "**After several months, and having a better idea of how this is going to transpire through this year, I think we will be better positioned** to think about what the implications might be for monetary policy."*

Bullard:

> *"Further policy **rate cuts are a possibility if a global pandemic actually develops with***

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> ***health effects approaching the scale of ordinary influenza,*** *but this is not the baseline case at this time," Mr. Bullard said in materials prepared for a presentation in Fort Smith, Ark.*
>
> *He told reporters after his speech: "I wouldn't want to prejudge the March meeting. Obviously, the situation is very fluid, and we are going to want to monitor events right up until the meeting." But he added, "****Focusing on central banks is probably not the best idea here****. The best idea is to focus on public health."*

Wow, so Bullard's hurdle for a rate cut is "effects approaching the scale of the flu." That's what, 12,000 deaths?!?

There's a raging debate in the market about whether or not the Fed should "respond" to a supply shock. The textbook answer is no, the Fed should not "respond." The problem is that many have ill-defined "respond," by forgetting the Friedmanite adage that you cannot assess the stance of policy by looking at the level of interest rates.

The Fed should not alter their policy stance, but the Fed Funds target is not equal to the "policy stance." Here's the Market Monetarist Blog with a helpful post this week:

> *…as long as the 'corona shock' is a negative supply shock then central banks shouldn't (as they really can't) try to do anything about it.*
>
> *However, that is much less straight forward than it sounds because what does "doing nothing" really mean?*
>
> *The natural interest rate is not constant. It moves for all kind of reasons – for example risk appetite, demographics and structural growth trends.*
>
> *This also means that the natural interest rate should be expected to be moving in response to supply shocks. Hence, we should expect the real natural interest to move down when the economy is hit by a negative supply shock.*
>
> *Consequently, an interest rate-targeting bank should cut rates to reflect the drop in the real natural interest rate triggered by a negative supply shock.*
>
> *This is NOT an easing of monetary conditions. It just ensures that monetary conditions are keep unchanged.*
>
> *This is an extremely important point. If the central bank does not want to do "anything" then it needs to cut interest rates in response to a negative supply shock.*

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> *This can seem paradoxical but is a logic consequence of the kind of interest rate targeting regime both the ECB and the Fed operate.*

Here's a great analogy that someone posted in the comments of a Scott Sumner Blog Post:

> *My driving policy is to stay 2 to 2.5 seconds behind the car a front of me at all times. To do that speed up and slow down as needed to stay in that window.*
>
> *If I'm accelerating and decelerating, it doesn't mean I've changed my policy. It means I'm **implementing it.***

I fear the Fed might be getting caught up in all this rhetoric about the "Fed put." It's not clear that there really is a Fed put, but **it certainly tends to look that way**. It's not that the Fed wants to "bail out markets" per se, but because they have been running a persistently tight monetary policy in the post-crisis period, markets periodically threaten to tip us into deflationary conditions.

Having undershot its inflation target for the entire post-crisis period, the Fed has zero justification for sitting pat while a market meltdown threatens to throw the economy into a deflationary recession. These market "tantrums" shouldn't be blamed on the childish misbehavior of market participants, but are the natural response to a lack of financial "mother's milk" from a neglectful Federal Reserve. Eventually, the Fed does respond to the blood-curdling screams, lest child protective services show up to take custody.

So, is this the Fed responding to the screams at 2:30pm on a Friday?

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Press Release

February 28, 2020

Statement from Federal Reserve Chair Jerome H. Powell

For release at 2:30 p.m. EST

Share

The fundamentals of the U.S. economy remain strong. However, the coronavirus poses evolving risks to economic activity. The Federal Reserve is closely monitoring developments and their implications for the economic outlook. We will use our tools and act as appropriate to support the economy.

For media inquiries, call 202-452-2955

It sure is strange that the Chairman would put this out just after a steady stream of his colleagues expressed such relaxed postures. Is he going to try to steamroll the committee and convene a conference call for an emergency rate cut? That would be out of character, and it's not at all clear that he possesses the gravitas to bend the committee to his will.

Powell is not on the Fed speech calendar for next week – the last before the pre-FOMC blackout period goes into effect on March 7. Perhaps he simply wanted to get in a dovish marker to avoid the possibility of a late-Friday market swoon? Whatever the case, it's not an action that will help to dispel the "Fed Put" impression. Ugh.

I see three scenarios for March FOMC:

1) They blow us all up by obtusely "laying the groundwork" for a future cut
2) They cut 25 – too little, too late in response to an ongoing market meltdown
3) They move boldly with 50bps

Markets are crying out for bold action that would provide assurance that the Fed is not going to compound a daunting supply shock with the deflationary error of mistaking the intertest rate target for the policy stance. If they respond aggressively they can cut off the extent tail risk of deflationary crash.

Unfortunately, the Fed's track record would favor option 2 – too little, too late - with the risk skewed towards option 1 (blowing us all up). I hope they surprise with aggressive action and am prepared to respond bullishly if they do so. But hope is not a strategy.

On to the links…

Obviously, the coronavirus is spreading worldwide with unpredictable consequences for supply chains and global growth. The spread has taken the focus off of China, where authorities are strongly pushing the narrative that they've solved the problem. They haven't. There is a high risk of renewed outbreaks in China becoming too big to cover-up, which could

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prove a catalyst for further market losses.

Protecting Beijing critical in China's COVID-19 battle

Beijing is facing mounting pressure in efforts to contain the novel coronavirus outbreak (COVID-19) as new confirmed infections surged due to imported cases of infection and cluster outbreaks.

Officials from the Chinese Center for Disease Control and Prevention (China CDC) confirmed Thursday that the authorities put the capital on top priority of its epidemic prevention and control work, with ***measures benchmarking those adopted in epicenter Hubei*** *and execution even more rigorous and decisive.*

Chinese top leaders urged all-out efforts in containing the virus spread in the capital, as its stability and security is directly relevant to the overall work of the Party and the country.

If anyone's planning a hack on China, now may be an opportune time…

Virus cluster at 'work unit' believed to be China's cybersecurity agency

China's cybersecurity agency is believed to be the latest place in Beijing to be hit by an outbreak of the deadly coronavirus that was first reported in Wuhan and has spread around the world.

Pang Xinghuo, deputy director of the Beijing Centre for Disease Control and Prevention, on Thursday said a cluster of infections had been identified at a "work unit" in the Chinese capital early this week.

While Pang did not name the work unit, she did give its location – at the same address as the National Computer Network and Information Security Management Centre, China's top cybersecurity agency.

Pang said 178 people from the affected work unit had been isolated for medical observation, including 11 who had tested positive for the coronavirus.

Ten of the 11 confirmed cases were employees of a property management company that provided services to the work unit, while the other person worked for a catering company, she said.

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Pang said health authorities believed the cluster of cases was the result of ***cross-infections that took place in the dormitory*** *and canteen of the property management firm.*

China Economy & Finance

I would not recommend getting caught up in the market obsession over this weekends' China PMI figures. The appearance of normalcy is an existential political requirement right now, so that is what we're likely to get. The only data I'd expect much insight from in coming months will be the amount of credit which proves necessary to avoid widespread bankruptcy and layoffs. Expect the volumes to be eye-watering…

China's Q1 car sales to drop 60% due to factory closures

Auto sales are expected to fall at least 90% in February, 60% in March and 40% in April, Jia Xinguang, a veteran car industry observer, told the Global Times on Monday, noting that this is an "optimistic" estimate.

"Due to the impact of the epidemic, sales are weak and dealers cannot generate positive cash flows," Jia said.

Another concern is that car dealers now have limited vehicles in their inventories.

Cui Dongshu, secretary general of the China Passenger Car Association, told the Global Times on Monday that some dealers' inventories are very tight as a result of production disruption.

"Hubei is home to the final assembly lines for automobiles, accounting for one-tenth of the country's car production chain, and while this part of the process could be moved to a less affected area, it may not be cost-effective to many car makers," Cui said.

I love this promo: "Buy two, get one free!"

China Developers Face Cash Crunch as Virus Freezes Home Sales

Fantasia Holdings Group Co. has upped the ante even further, with a 'buy two apartments, get one free offer,' and is taking deposits of as little as 1,777 yuan. Not only that, if a buyer backs out within 30 days, they get their deposit back, plus interest.

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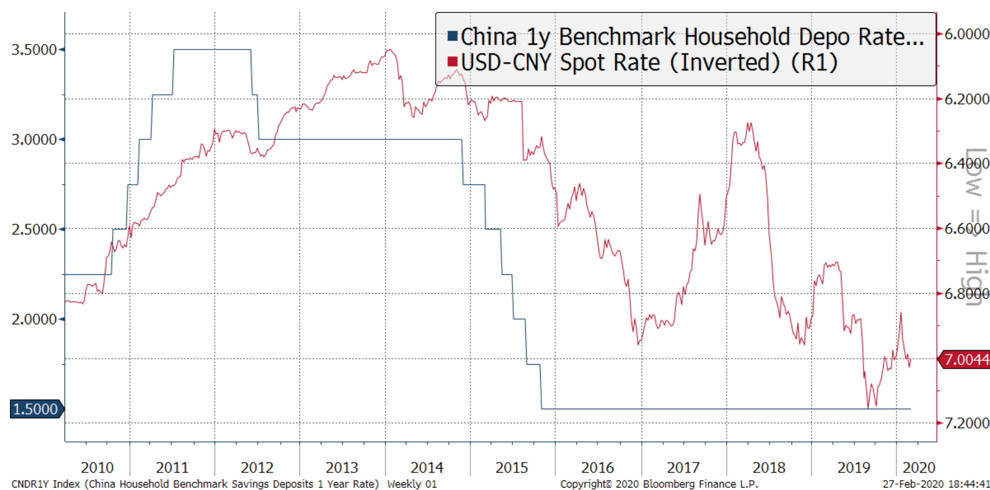
Policy action to this point has been a lot of sound and fury, signifying nothing. RRR cuts, as always, are largely a smoke screen. The SME sector needs a large government-funded subsidy program in some form, but there is no talk of that yet. The other broad stimulus measure they could pursue is a cut to benchmark deposit rates (PBoC facilities like the MLF provide only a tiny slice of bank funding, the bulk of which is still in the form of deposits).

Key measures set to shore up economy

> *The central bank will carry out "dynamic adjustment" in its policy for commercial banks' reserve requirement ratio in the targeted manner in the near future and will ensure financing to be more inclusive and supportive for smaller firms, Chen Yulu, a deputy governor of the PBOC, said on Monday.*
>
> *There are also discussions among economists about **the possibility of the central bank cutting the benchmark deposit rate**, which has remained unchanged since 2015. Liu Guoqiang, another PBOC deputy governor, said recently that the central bank will consider adjusting the benchmark deposit rate based on economic growth and price level at an appropriate time.*
>
> *Analysts said that the emphasis on flexibility and a targeted approach in monetary policy underscored the government's intention to inject more liquidity to support the epidemic-hit economy, while **it remains very cautious about excessive easing** that could lead to a steep rise of asset prices in the capital and property markets.*

The problem with a benchmark deposit rate cut is that its already at 1.50%, and as they approach zero they may find a non-linear increase in capital outflow urgency.



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Another smokescreen: infrastructure announcements are a regular feature of the Chinese policy landscape. They mean nothing unless they are funded, and funding is going to be sorely lacking this year (because much government borrowing will have to go to industrial sector and SME subsidies, leaving precious little for bridges and tunnels).

Local governments have announced 11 trillion yuan projects to boost economy

> *Local governments including Beijing, Fujian province, Henan province, Yunnan province and Jiangsu province have announced their lists of key projects for 2020, involving combined more than 11 trillion yuan investment*

This is the kind of thing we might yet see in China – a HKD 10k per head give-away to all permanent residents announced in this week's budget. China would money-finance such a program, making it genuine "helicopter money." But note that in Hong Kong's case it was **not helicopter money**. The handout is funded out of the Fiscal Reserve, which is on deposit at HKMA. HKMA will sell USD / Buy HKD and hand the HKD to the government, who will re-inject them in the form of the 10k per head payout. The PBoC balance shrinks, but there is **no net creation of HKD**.

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The HK handouts are being financed, not by new HKD issues, but out of the governments HK$1.1 trillion fiscal reserve: hongkongfp.com/2020/02/26/hon...

George Selgin @GeorgeSelgin · Feb 26
The FT really dropped the ball on this. Not only is the cash handout not "helicopter money," but the HK gov't has made similar handouts repeatedly since 2011: businessinsider.com/hong-kong-chan... twitter.com/AnttiHuotari7/...

8:13 AM · Feb 26, 2020 · Twitter Web App

U.S. Politics

This piece seems less apropos with the stock market crashing and recession beckoning. Certainly, against the backdrop of a robust economy a Sanders nomination could really hurt the Democrats "down-ballot." I would not bet against the Republicans taking back the House in that scenario.

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As it stands today however, we are at risk of an eco-political **doom loop: markets swoon -> Bernie risk rises -> markets swoon**…

The Price of a Sanders Nomination

> *Supporters of Senator Bernie Sanders insist that their guy can eject Donald Trump from the White House. The more insistent question, though, is whether Sanders will cost Democrats the House of Representatives.*
>
> *Democrats won the House in 2018, riding a surge of anti-Trump voting from a constituency that's been scared by the Sanders campaign: older, college-educated, conservative-leaning women. Such voters tipped into the Democratic column the congressional seats once held by George H. W. Bush, Newt Gingrich, and Eric Cantor.*
>
> *In 2018, upmarket districts voted to reprimand the president's language and behavior. A Sanders nomination invites those districts to vote in 2020 to raise their taxes and replace their health insurance. That may be a tougher sell.*
>
> ***The Democratic House majority is new, fragile, and dependent on voters who are more conservative than the median Democrat****.*

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