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Markets in High Resolution

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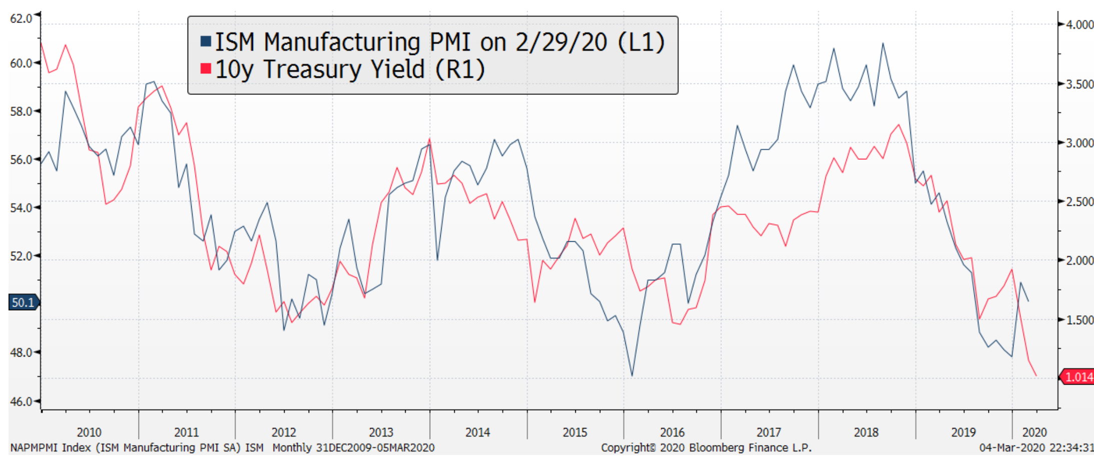
CaronaCrash Roadmap

Bullish: Jay Powell Gets It

- I've been critical of Powell, but **the 50bp cut was the right move**.
- No, the Fed can't "print a vaccine."
- However, the **Fed could exacerbate the supply shock with a passive tightening** of monetary policy, by failing to respond to the drop in the neutral rate.
- Avoiding this error **reduces the left-hand tail** of a debt-deflation accident.
- The "emergency" move shows that **Powell "gets it"** – an important boost to market confidence. Sometimes you're supposed to panic.

Bearish: We're Heading into a Growth Recession

- The market's choppy, ambiguous response to the rate cut makes sense from the perspective that all the Fed can really do here is avoid making things worse.
- The economy was already on recession watch as a result of the Fed's wholly unnecessary inversion of the yield curve last year.
- Despite widespread belief that yields are somehow "manipulated," **the bond market has consistently responded to cyclical impulses** and has been signaling subdued growth for many months (HT to my friend Mike Darda at MKM partners for this chart).



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- Discretionary spending and business investment in the U.S. are <u>**about to hit a wall**</u>.

- Supply-chain disruption will be widespread.

- Europe and Japan were already tottering on the brink. China has experienced a sudden stop. Global trade is likely to collapse.

- March data will be ugly (ISM 45?) and will probably set us up for <u>**near-zero growth or worse in Q2**</u>

<u>Liquidity Indicators: Good News, Bad News</u>

- Bad news: liquidity indicators never confirmed the post-Phase One Q1 Reflation Trade.

- Good news: they're generally not getting worse. Change since 2/19 S&P peak:

  - 10y-1y UST Curve: +35bps
  - 10y Inflation Breakeven: -23bps
  - Gold: +$40
  - DXY: -2.7%
  - CRB: -0.88%
  - Crude Oil: -11.9%

- It's a mixed bag (breakevens are worrisome but could be oil-influenced), but <u>**indicators broadly suggest this episode can be confined to a short-term growth recession**</u>, absent the self-reinforcing downside of a systemic credit event triggered by monetary error.

- The Fed has more work to do (another 50bps?) to ratify the market-led curve dis-inversion.

<u>Eventually Very Bullish: The Fed Will **Pivot to a New Regime**</u>

- The Fed wants to establish a more aggressive determination to hit the 2% inflation target, but had no obvious way of getting from here to there. The virus has provided that.

- The Fed will use this "emergency action" to pivot to a new, more inflation-friendly policy regime

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- Once the smoke clears, **rate cuts will be reinforced with forward guidance** detailing the inflations outturns required for another attempt at "normalization"

- If the virus blows over without undue economic damage, this is very bullish for risk assets "coming out the other side."

The Big Variable: **will the virus subside with warm weather?**

- No one knows for sure, but the weight of evidence suggests the answer is likely "yes."

- I don't think we're there yet, but at some point in coming weeks this becomes **a bet worth making** at lower levels of equity prices

China: "V-shaped recovery" is an utter fantasy

Dire 2020 Growth Outlook

- The economy is currently running at no more than 2/3 of capacity.
- Data shows <40% of migrant workers have yet returned to cities.
- **Q1 growth will be deeply negative.**

- There are 290m migrant workers, ~40% of China's workforce.
- Subsistence wages, crowded living conditions, **highly vulnerable to viral spread**
- If 20% opt for subsistence farming in the village, **China could lose 8% of its workforce**

- Hubei province – likely impaired for many months - accounts for **4.5% of China's GDP**

- There is great risk to the assumption of a quick return to normalcy in China's real estate market, as **systemic confidence is badly shaken**

- Data credibility: the continuation of draconian containment measures is wildly inconsistent with case data showing that "the coast is clear"

- Second round effects: China's **export markets are now getting whacked**.

- **Adhering to the 2020 growth targets is lunacy** of the first order. Official acknowledgment of the dire reality is likely before long.

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An Infrastructure Boom Would Be Folly…

- 2020 credit issuance would have been $4.5T in a normal environment.

- The virus leaves a large "GDP hole" ($1T?) that now must be filled with debt-funded tax cuts and subsidies to avoid mass SME closures and layoffs.

- The property downturn will further impair local government budgets.

- $6T in credit issuance is pushing 50% of GDP – is that even possible?

- **China can bail out SME's or fund an infrastructure orgy – not both**.

- The system may lack the policy subtlety to get this right. The situation requires a highly complicated "bottoms-up" subsidy scheme but "stimulus policy" works top-down (with massive leakage).

- Favoring infrastructure over SME subsidies will **ignite the debt bomb**, as it would entail piling on a lot more debt while allowing the main engine of debt-servicing capacity to break down.

- Cadre: "Boss, all of our SME's are going bankrupt."
- Xi: "Hurry up and build them a bunch more roads and bridges to use"

Market Outlook

- I'm **disinclined to bottom-fish** in equities with the outbreak just getting underway in the U.S., hellacious economic data to come next month, and systemic risk in China wildly underappreciated.

- Previous post-crisis wash-outs (2011, 2016, 2018) were caused largely by monetary error and therefor amenable to monetary fixes. This one is not.

- Even if the virus proves to be relatively easily contained, it will take some time to work through the consequences of a global "sudden stop."

- This chart outlines by my broad roadmap (subject to change as events unfold):

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- S&P 2600 might seem extreme, but if you haircut the current 2020 earnings consensus by 5% and put a moderately panicky 600bp equity risk premium on it (assuming a 1% 10y yield) you're looking at levels around 2400.

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