PENSFORD

July 27, 2020

Watching sports without fans proved that I wasn't as starved for sports as I thought. I can't do it. At least not yet. I think I would prefer to stay in my dark place and come out when things return to normal. I'm a Philadelphia fan, I need booing.

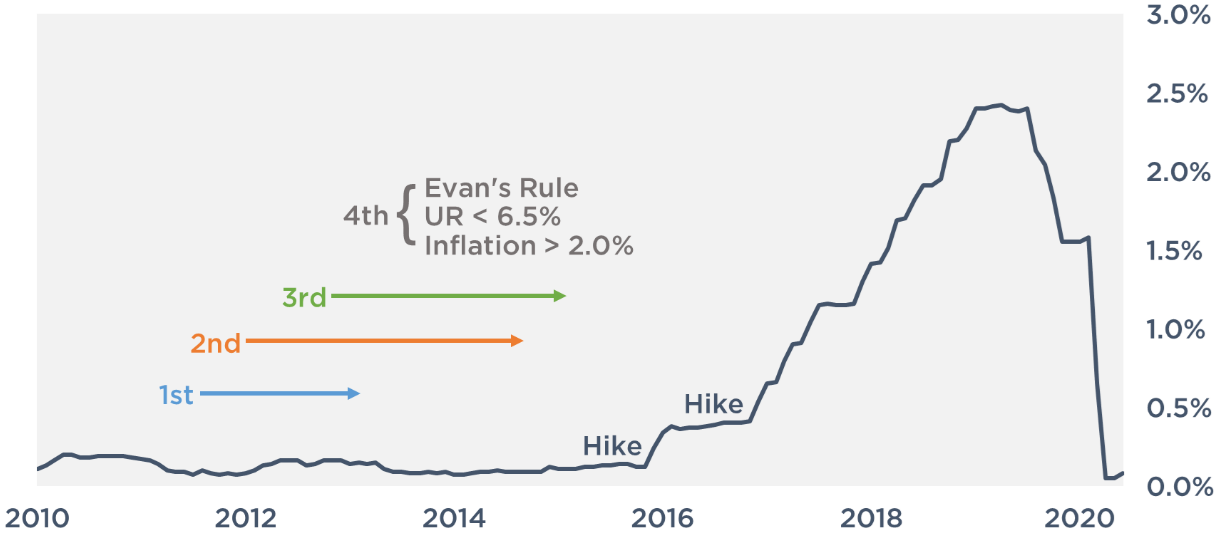
Last Week This Morning

- 10 Year Treasury closed down slightly at 0.58%, a few bps off the all-time closing low
    - German bund -0.49%
- 2 Year Treasury basically unch at 0.14%
- LIBOR at 0.17%
- SOFR is 0.10%
- Weekly jobless claims rose for the first time since the pandemic hit, increasing from 1.3mm to 1.4mm filings
- Pfizer will receive nearly $2B to produce and deliver 100mm doses of its vaccine candidate
    - Along with other early leaders, it feels like vaccines will be available as early as year end, but maybe not available for widespread distribution until Q2 2021
- The EU approved a $2T stimulus package
- The US's four largest banks increased capital reserves by $26B in Q2 for worse than expected loan losses
- June new home sales hit 13 year high
- Tensions with China are on the rise again, with the US closing a Chinese consulate in Houston and China retaliating in kind with the US consulate in Chengdu

FOMC Meeting – Wednesday

In 2011, the Fed committed to keeping rates unchanged until at least 2013. Then it revised that not once, not twice, but thrice (yes, that's a word…I learned it from the Simpsons). The last calendar-specific guidance committed to keeping rates at 0% until at least mid-2015.

Then, in December 2012, the Fed switched gears and followed the suggestion of Chicago Fed President Charles Evans. The new target would be sub-6.5% unemployment and above 2.0% inflation. The Fed's hiked once in December 2016 (a hike even Yellen would concede was made in error) and then began a tightening cycle in earnest in December 2017.



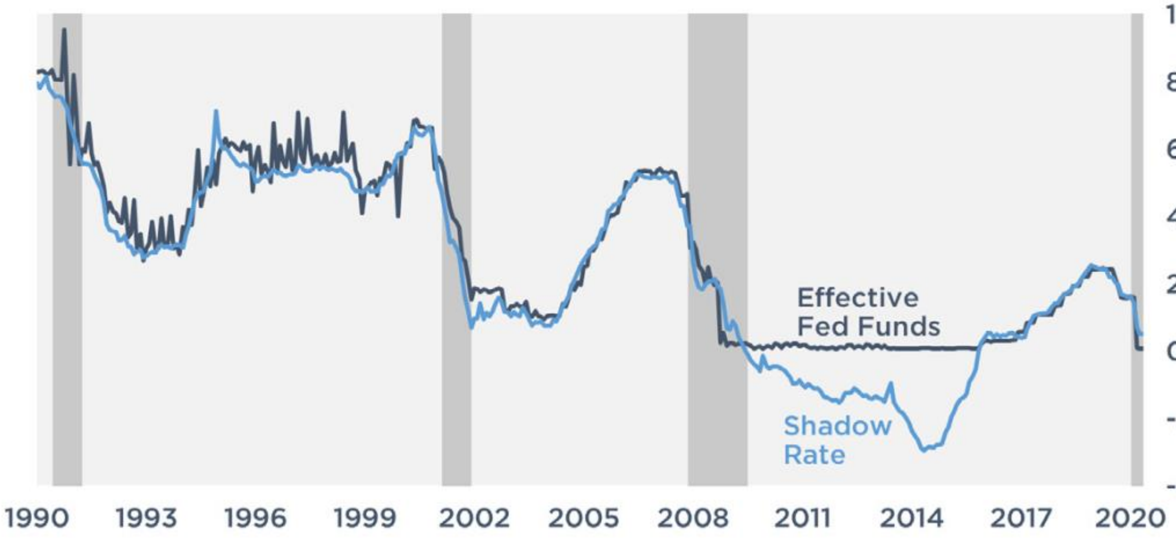
The Fed's current guidance is no change through at least the end of 2022. But if history tells us anything, it's that they will likely revise this and we will be dealing with 0% interest rates for at least three years.

The Fed meets again this week (Tue/Wed) with the formal statement Wednesday afternoon. I'm not sure this meeting carries much weight. Rates are on hold for the foreseeable future. Yawn.

There is chatter that the Fed will transition to data-specific guidance (eg, "We won't hike until unemployment is below X.XX% and inflation is above Y.YY%), but I doubt it. The Fed just committed to calendar-specific guidance, why would they move away from that already? Plus, there is so much noise in the data right now that pinning forward guidance to those numbers could create more, not less, volatility.

The bottom line is that we will be dealing with ZIRP for the foreseeable future. In fact, true interest rates are likely to push deeply negative over the next three years. You may recall our discussion about the Wu-Xia Shadow Rate. I talked about this a lot several years ago and then brought it up in April after I emailed them to see if they would be updating their graph. And they did!

Two Atlanta Fed economists determined that real interest rates, or the Shadow Rate, went deeply negative following the financial crisis. The Shadow Rate detached from the published Fed Funds rate once it went below 25bps. Once the Fed started hiking again, the relationship between real and published rates returned and the Fed Funds rate we read in the WSJ is accurate.



With Fed Funds set to 0% again, we will likely experience negative interest rates in the US again. Previously, they bottomed out at -3.0%. Things like forward guidance, QE, stimulus, etc all contributed to negative interest rates.

When did your business *start* rebounding following the financial crisis? If the answer is 2012-2014, negative real interest rates likely contributed mightily. If you remember business slowing down in 2015, that's partly because rates were climbing so sharply. Going from -3.0% to 0% is similar to going from 0% to 3.0%.

Here's what financial conditions have looked like since the financial crisis. Look how accommodative things were in 2014.

Source: Bloomberg Finance, LP

1300 South Mint Street, Suite 410 (704) 887-9880

Charlotte, NC 28203 Pensford.com

The recession may already be over and the Fed is all-in on creating an accommodative environment for the next several years.

That Stimulus Tho

Lots of support ending soon.

- Enhanced unemployment benefits end on Friday
- Moratorium on evictions ended over the weekend
- Forbearance programs
- Student loan payment freezes end in September
- PPP covered 2.5 months of payroll and expenses, which has passed for most
- Airlines that accepted aid can begin laying off workers at the end of September

I appreciate fiscal conservatism, but a pandemic is not the time to be climbing on a soapbox about spending. The economic loss of a protracted recession exceeds the price tag of a $1T-$3T spending bill.

If anyone else is surprised that the downturn hasn't felt as bad as we were expecting, that's because the massive federal intervention worked. Period. Stimulus works. Period. To pull back now would jeopardize the recovery. Maybe we can all agree that accommodation should be removed more quickly once the recovery is underway and we shouldn't be relying on QE and ZIRP for a decade.

Assuming Congress passes a second round of stimulus for $1T, Bloomberg Economics forecasts GPD for 2020 to come in at -6.5%.

But without a second round, that drops to -10.0%.

Their report also suggests 2021's recovery would be more shallow, coming in at 4.2% instead of 5.2%.

We're going to be footing that bill one way or another, let's minimize the pain. Second half GDP is expected to contract $650B, let's not make is any worse. The bold, aggressive intervention in March is a large reason why the economy hasn't fared worse. We need more, not less, of the same.

I am fully on board with mitigating this perverse incentive system with an *additional* $600/week. Too many people are making more money being unemployed. But it shouldn't be eliminated entirely, either. June retail sales were down just 0.6% from pre-covid levels – that's not a coincidence.

The Census Bureau indicates 20mm Americans have low or no confidence in their ability to make their next rent payment while 7.8% of mortgages are in forbearance. The Dallas Fed suggests real unemployment peaked in May at 24.7% and ended June at 17.7%, with an implied unemployment rate today of about 15% (this survey also asks those that are unemployed today, but had a job in February, if they expect to be able to return to their old job and the % that say "no" has increased from 18% to 32%).[1]

15% unemployment rate is not the time to be arguing over stimulus (especially if you want to get re-elected in three months).

A deal will get done. It may not happen by Friday, but it will get done. Depending on the size and scope, this could push the 10 Year Treasury back up into the 0.75% range.

Week Ahead

FOMC meeting this week along with some significant eco data, notably Q2 GDP and inflation.

Sources

1. https://www.dallasfed.org/research/rps/2020/rps200619