Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Michael Warren, Energy Strategist

MACROCOSM

Covid-2019 Becomes Covfefe-2020

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Donald Luskin

Politicization of the crisis risks dangerously recessionary self-fulfilling prophecies.

Asset markets are now more than fully into the correction we expected all along (see “Is Coronavirus a Chinese Bio-Weapon?” February 3, 2020).

- Objectively, *the epidemiological data has gotten slightly worse* since we reported some progress two days ago (see “Covid-2019 and Bernie-2020” February 26, 2019). In China, new cases have crept slightly from the recent lows, but are far from the highs, and deaths have fallen. Ex-China, new cases have risen to just under 1,000 (more than half of that is S. Korea), and deaths have risen to 15, but the total remains only 70 (please see the charts below).
- Subjectively, *this is turning into a panic, and a political circus, which courts the risk of becoming a recessionary self-fulfilling prophecy*.
- *The political dimension in the US is worrisome for multiple and*

Update to strategic view

US MACRO, US STOCKS, US FED, OIL: Markets are in the deep correction we expected in response to the Covid-2019 epidemic. The objective epidemiological data has gotten just slightly worse, but subjective sentiment has worsened considerably, goaded on by a “blame Trump” political circus. This makes government response more difficult and complex, and erodes confidence. The worst case is that it weakens the economy sufficiently to thwart Trump’s re-election, the fear of which would “reflexively” weaken the economy further. It likely creates both a demand effect and a political rationale for the Fed to cut rates in March. A cut can’t cure Covid-2019, but the Fed was too tight to begin with, and a cut can ease financial conditions that the virus tightened further. OPEC is likely to announce production cuts. The S&P 500 equity risk premium is near the widest since the end of the Global Financial Crisis. The atmosphere of panic has made equities very cheap, suggesting at least some timid dip-buying.

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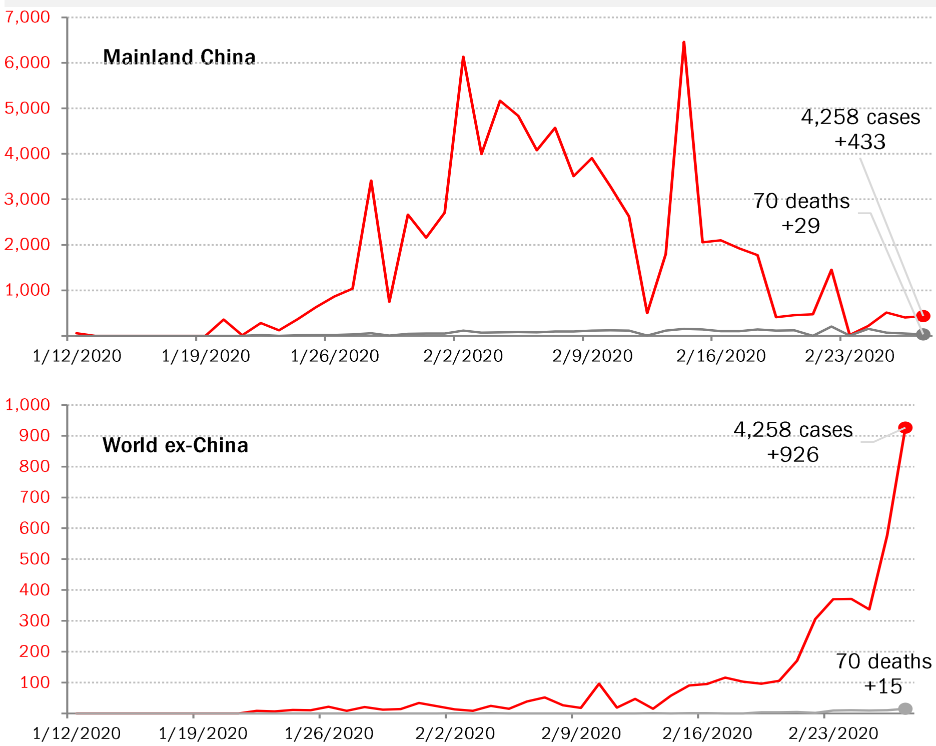
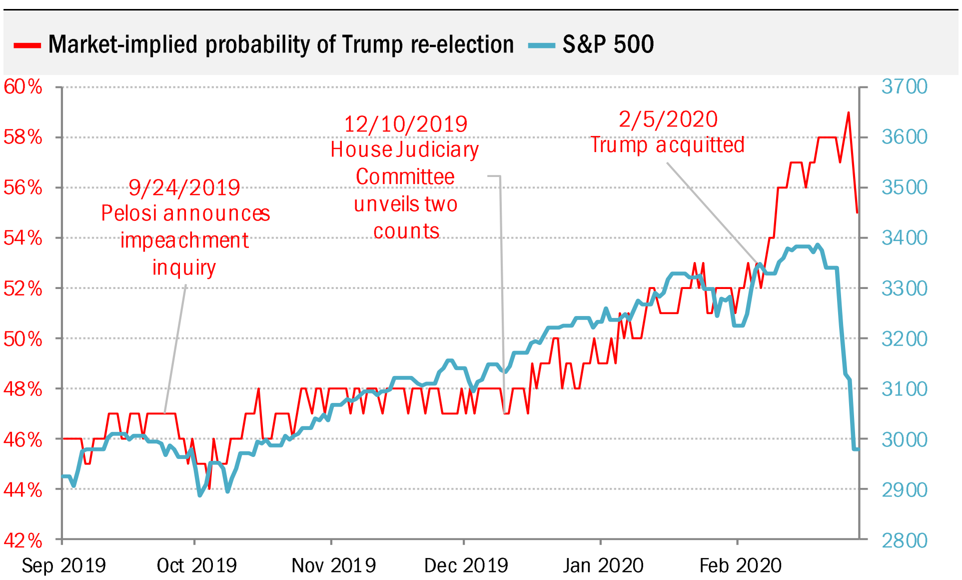
Covid-2019 daily confirmed cases and deaths



Source: John Hopkins, TrendMacro calculations

- *interconnecting reasons.*
- *Regrettably, we have no choice but to make the judgment that in this election year the Democrats are using the coronavirus crisis to undermine President Donald J. Trump – the way George W. Bush was undermined in the Hurricane Katrina crisis in 2005.*
- *This "blame Trump" gambit makes competent and expedient government action more difficult, by making every decision a matter of politics, taking the focus off crisis-management, and reducing public confidence in statements by public officials.*
- *It also entails deliberate panic-mongering. Altogether it inflames the risk of recessionary self-fulfilling prophecies as economic actors, at the margin, pull back from consumption and investment activities.*
- *Indeed, while this is not something we prefer to believe about any public official, the economic impact is not a side-effect, but a core purpose of this political gambit. The weaker the economy gets, all else equal, the less likely Trump is to get re-elected* (see "Video: TrendMacro's 2020 election model" March 15, 2019).
- You be the judge as to whether this is a "conspiracy theory." The present panic kicked into high gear for the first time on Tuesday with the extremely alarming remarks of the seemingly authoritative Dr. Nancy Messonnier, an official of the Centers of Disease Control – "not when but if," "severe illness," "disruption of our lives" and so on." It turns out that Messonnier is the sister of Rod Rosenstein, the former deputy attorney general who appointed Robert Mueller to investigate Trump. The relationship is documented on Rosenstein's Wikipedia page (Messonnier's page, as of this writing, has been taken down, though it is still linked on Rosenstein's).
- If that's too Rush Limbaugh for your tastes, in our view it is sufficient to note the cavalcade of over-the-top criticism of the Trump administration's crisis-response from Democratic leaders, spokespersons and presidential candidates (well documented this morning by our friends at the *Wall Street Journal* editorial page).
- *In the manner of George Soros' "theory of reflexivity," to the extent*



Source: Predict-It, Bloomberg, TrendMacro calculations

Contact TrendMacro

On the web at
trendmacro.com

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twitter.com/TweetMacro

Donald Luskin
Dallas TX
312 273 6766
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

Michael Warren
Houston TX
713 893 1377
mike@trendmacro.energy

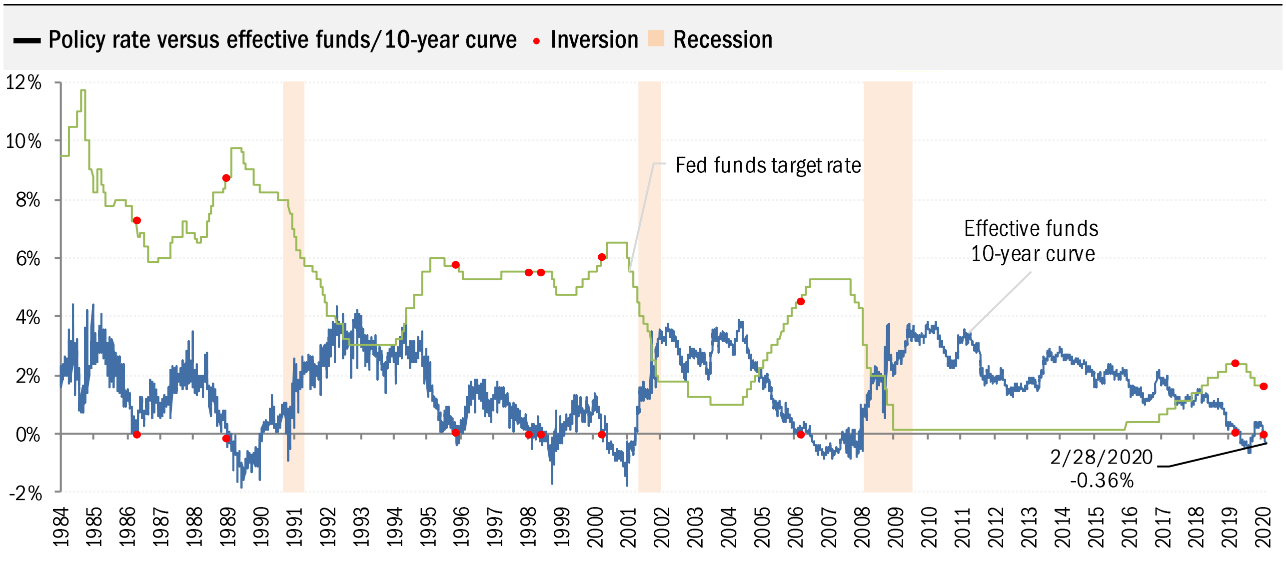
[About us]

that all this is effective, the less likely becomes Trump's re-election, and as a result, the weaker the economy will get because it will have to discount the repeal of Trump's pro-growth policies and the imposition of anti-growth policies (see "2020 Outlook: After a Near-Miss Recession, It's the Election" January 2, 2020). *That, in turn, reduces Trump's re-election chances further, and so on and so on.*

- So far there is only mixed evidence that this is playing out. Our quantitative presidential election prediction model still forecasts that Trump will be re-elected by a very wide margin. For all the political acrimony this week, Trump's net approval stands as of this writing at +5%, the highest during his entire presidency. On the negative side, political futures markets now give Trump a 55% probability of re-election, 4% off their recent all-time highs, even as they have sharply broken from their tight relationship with the stock market (please see the chart on the previous page).

Among the critical government responses potentially distorted by the politicization of the crisis is that of the Federal Reserve – but in that case the distortion proves to be salutary.

- The money-market curve is now more than fully discounting a rate cut at the March FOMC meeting, which we predicted two days ago (again, see "Covid-2019 and Bernie-2020") – and then further cuts down the line.
- *The politicization of the coronavirus crisis will likely goad the Fed forward on this by raising the political risk of appearing non-responsive.*
- *But what's more, the Powell Fed has proven it can act when it can do so under the banner of a "blame Trump" narrative.* The last time Fed Chair Jay Powell was roused to action was mid-last year, in the wake of Trump's threat to impose tariffs on Mexico. The threat was withdrawn after Mexico quickly acceded to Trump's demands for better border security (see "Video: What you're not hearing about Trump's tariff gambit with Mexico" June 9, 2019). But in the midst of it, for the first time since Powell's Fed over-tightened throughout the back half of 2018, Powell signaled that cuts were coming, necessitated by "trade negotiations and other matters" (see "On the June FOMC" June 19, 2019).
- *We are hearing from many clients in the present atmosphere of panic and despair that a rate cut will only be a desperation move with no hope of helping matters.*
- *We strongly disagree. To be sure, monetary policy is not an inoculation against viral contagion, but it is an inoculation against financial contagion.*
- And now, just like last year, the Fed is too tight anyway. It needs to cut, virus or no virus. The yield curve between the effective funds rate and the 10-year yield – the curve that Powell himself monitors for market-implied evidence that policy is too tight (please see the chart on the following page, and "Video: What Jay Powell should be telling you about the inverted yield curve" April 1, 2019) – was already flat at the last FOMC meeting before the Covid-2019 panic kicked in. Foolishly, the FOMC inverted the curve by raising IOER,



Source: Bloomberg, TrendMacro calculations

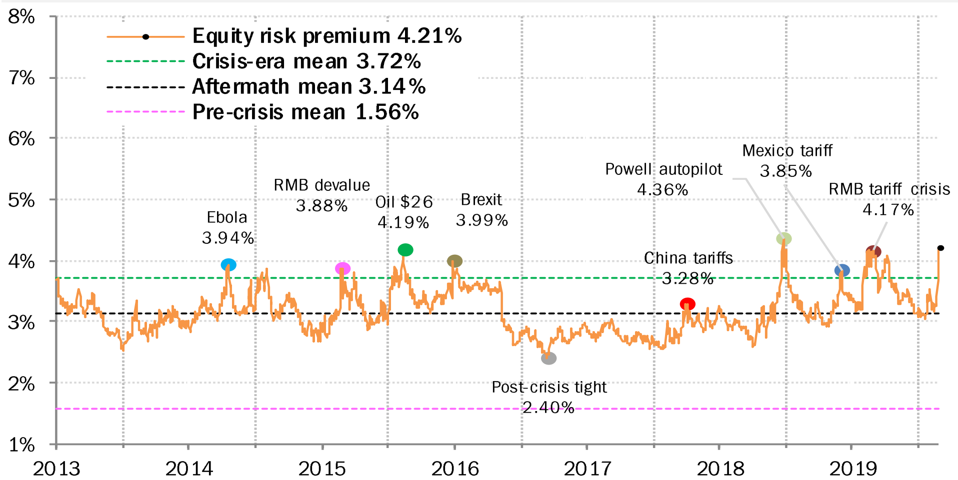
the interest rate paid on reserves (see "On the January FOMC" January 29, 2019).

- *As of this writing, that curve is inverted by 36 bp – a March rate cut, all else equal, wouldn't even fully dis-invert it.*
- Even disregarding those initial conditions, the present slowdown of economic activity that began with the lock-down of Chinese cities unambiguously tightens financial conditions by lowering the natural rate of interest. By driving oil prices lower, it has fed into a blow-out in US non-investment grade credit spreads, and lowered inflation expectations – both of which further tighten financial conditions.
- The Fed needs to lower policy rates to at least track the lower natural rates. One doesn't need to believe that the Fed will save the world by doing so. That isn't the standard. *If the Fed does not cut rates, the present crisis will have passively made the Fed even more too tight than it already was – it must cut rates simply to avoid that error which would make matters even worse.*
- We are not put off our conviction that the Fed will cut in March by the statement of ECB President Christine Lagarde that "we are certainly not at that point" where the ECB must act. Of course she would say that, because there is nothing the ECB can do that it hasn't already done. The previous day, when fiscal stimulus in Germany was on the table, she had said "any fiscal measures intended to support the economy are certainly very welcome, particularly under present circumstances."
- *Similarly, we expect OPEC will announce temporary production cuts in order to prevent the oil price from falling even lower.*
- The cartel failed to do so at its recent *ad hoc* meeting, perhaps because collective action became impossible after Saudi Arabia made the blunder of announcing, before the meeting, that it would cut unilaterally if necessary. Oil had already fallen 26% from its early-January spike (see "After Soleimani, What If Peace Breaks Out All Over?" January 6, 2020). Now it's fallen another 10%, and OPEC's leadership has signaled that talks are on again.

While there is much that is going wrong here – and the potential for self-fulfilling prophecies and vicious cycles – it is also the case that a great deal has already been discounted, in what is being touted in the financial media – in particular, [the financial media owned by presidential aspirant Michael Bloomberg]() – as “the fastest stock market correction on record.”

Indeed. That correction has brought the S&P 500 equity risk premium up to an extremely attractive level (please see the chart below). *The ERP at 4.21% (as of last night’s close) is wider than at any time since the end of the Global Financial Crisis, with the exception of the December 2018 Powell “autopilot” fiasco, when it got as wide as 4.36%.*

S&P 500 equity risk premium (forward earnings yield minus 30-year Treasury yield)



Source: Various, TrendMacro calculations

- We said Wednesday that it was “probably the time to at least start buying the dip.” That call was early, but at least it was timid.
- Shall we reiterate today?
- At this point, we’re seeing a paradox. To be sure, the subjective and political elements of panic have worsened, and they are real and dangerous, and we will be tracking them. But they can also drive useful responses – as we believe they will in the case of the Fed – and they certainly serve to make asset prices attractive. So yes, we will timidly reiterate today. This is “probably the time to at least start buying the dip.”

Bottom line

Markets are in the deep correction we expected in response to the Covid-2019 epidemic. The objective epidemiological data has gotten just slightly worse, but subjective sentiment has worsened considerably, goaded on by a “blame Trump” political circus. This makes government response more difficult and complex, and erodes confidence. The worst case is that it weakens the economy sufficiently to thwart Trump’s re-election, the fear of which would “reflexively” weaken the economy further. It likely creates both a demand effect and a political rationale for the Fed to cut rates in March. A cut can’t cure Covid-2019, but the Fed was too tight to begin with, and a cut can ease financial conditions that the virus tightened further. OPEC is likely to announce production cuts. The S&P 500 equity risk premium is near the widest since the end of the Global Financial Crisis. The atmosphere of panic has made equities very cheap, suggesting at least some timid dip-buying.