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TRENDMACRO LIVE!

On the Fed's Massive Intervention

Monday, March 23, 2020
Donald Luskin

It blunts the systemic edge of the crisis, but it takes the pressure off the Senate.

The Fed announced this morning unlimited purchases of Treasuries and MBS – and corporate bonds and associated ETFs – and several new lending facilities, as part of the bidding war for "stimulus" that we have expected (see "Powell Not to the Rescue" March 4, 2020). This super-quick note covers a few of our initial thoughts. We'll say more when we have absorbed more of the details.

- *This intervention significantly reduces the systemic aspect of the Covid-2019 crisis.* We said two weeks ago the advent of systemic risk would transform the dimensions of the risk-off move in markets from that of a correction to that of a bear market (see "Just What We Didn't Need: An Oil Price War" March 8, 2020). Now that bear market has exceeded our projection.
- With the systemic element reduced, it's a good time to note that on Friday the S&P 500 equity risk premium at 5.95% (please see the chart below) came within spitting distance of its euro crisis peak on June 11, 2012 (6.06%) and its Global Financial Crisis peak on March 9. 2009 (6.17%). *With relative valuations this compelling, and a "whatever it takes" move by the Fed, it's time to take another*

Update to strategic view

US FED, US MACRO, US EQUITIES: The Fed announced unlimited QE and new credit facilities, blunting the systemic aspect of the Covid-2019 crisis. The S&P 500 ERP is near its peaks in the euro crisis and Global Financial Crisis, so with the Fed having made a pre-emptive move, it's time to make another timid averaging-down bite. Unfortunately, the Fed took the heat off the Senate, where Democrats are blocking relief. But…

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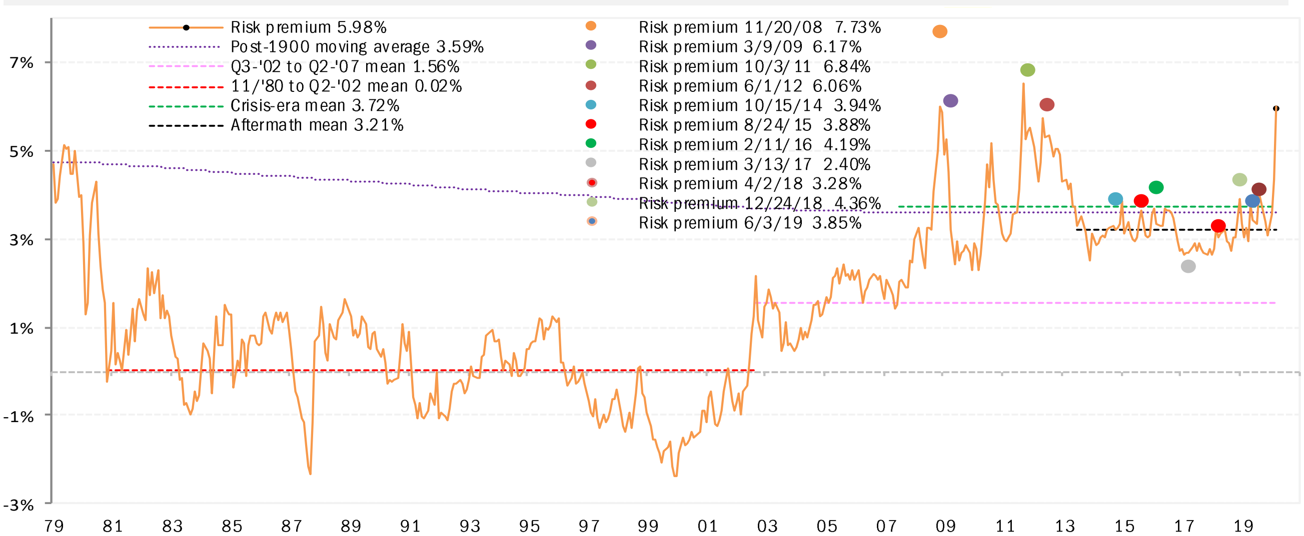
S&P 500 equity risk premium. month-end   Significant dates, and 3/23 datapoint are intra-month



Source: Various. TrendMacro calculations *timid averaging-down bite*.

- Unlike the prior crisis-points that commanded similar ERPs*, this time the Fed has intervened pre-emptively*, before anything has actually gone wrong. Pre-emption isn't always a virtue. There is much about this whole Covid-2019 episode that strikes us as more than a little panicky – bearing great economic costs with very little actual epidemiological data. But when it comes to providing just-in-case liquidity, count us in. The best time to prevent a run on the bank is before you see depositors lined up around the block.
- That said, there are dimensions of relief to the economy that the Fed can't provide – such as enhanced unemployment benefits, or credit for non-investment grade corporates. That's going to be up to Congress, and unfortunately *the Fed's intervention this morning takes some of the heat off the Senate*.
- A massive relief bill is being blocked by Democrats who are, if we may be frank, holding the economy hostage over various "progressive" demands as conditions for any corporate aid (see "Worst Coronavirus Idea: A Ban on Share Buybacks" March 23, 2020). Maybe that's why markets are off their overnight lows on the news, but not exactly celebrating as of this writing. Another limit-down day in US equities might have clarified a few minds on Capitol Hill at this morning's next procedural vote.
- But *the Fed lubricates the Senate's decision-making process by stepping up as a buyer of new Treasury debt that would have to be issued to fund a relief bill*. We've said that this can be thought of as an experiment in so-called "Modern Monetary Theory" (see "Are You Feeling Stimulated Yet?" March 18, 2020) – in which we'll just have to see how much debt our central bank can monetize without triggering an inflationary breakout
- So far so good on that for over a decade now – in fact, by central bank standards, inflation has been too low all along. At the paradigm level, inflation occurs when the supply of money outstrips the demand for money. It would seem that an element of the "new normal" is that there is a greater than expected demand for money, because the inflation just isn't there.
- *All that said, the world isn't going to get out of the Covid-2019 crisis without cost*, given the draconian responses that have emerged to deal with it. The issue going forward is to preserve the economic wherewithal to support a rapid and robust bounce-back. So far so good on that, too.

Bottom line

The Fed announced unlimited QE and new credit facilities, blunting the systemic aspect of the Covid-2019 crisis. The S&P 500 ERP is near its peaks in the euro crisis and Global Financial Crisis, so with the Fed having made a pre-emptive move, it's time to make another timid averaging-down bite. Unfortunately, the Fed took the heat off the Senate, where Democrats are blocking relief. But QE lubricates the legislative process by providing a funding path. It's an experiment in "Modern Monetary Theory," where we will just have to see whether the demand for money is sufficient to meet the new supply and keep inflation in check. Given the draconian response

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…QE lubricates the legislative process by providing a funding path. It's an experiment in "Modern Monetary Theory," where we will just have to see whether the demand for money is sufficient to meet the new supply and keep inflation in check. Given the draconian response to Covid-2019, there will be costs – the important thing is to preserve the ability of the economy to bounce back rapidly and robustly.

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