Financial Markets Perspective

April 2023

The Financial Impact of the Pandemic and Beyond

Here we are three years along from the onset of the Covid 19 pandemic, an event that has had a world-shaking impact on global economies and financial markets. More important than the pandemic itself were government responses that turned economies topsy-turvy and changed our lives forever. Over these three years, we have been on a roller coaster ride with all the equivalent thrills and fears. At first, we had to experience the questions around the virus itself and the instructions given to us by governments, i.e., mask or do not mask? Then came the shutdowns. No more going out to dinner with friends. Suddenly, there was additional money in our bank accounts -- government handouts. Great! But why exactly are we receiving this “free” money? The latter sent financial markets into an upward spiral that had no end in sight!

The stimulus came in the form of massive fiscal spending programs exceeding five trillion dollars, programs that essentially gave money to individuals and companies for doing nothing. At the same time, the Federal Reserve lowered interest rates (as measured by the fed funds rate, the rate that banks charge each other for overnight loans) to zero. For an economy attempting to recover from the shutdown, these government programs appeared to go too far. As a result, euphoria prevailed in risky assets such as cryptocurrencies, NFTs (non-fungible tokens) and SPACs (special purpose acquisition companies), and private equity deal-making. Day traders borrowed what was essentially free money to speculate on anything!

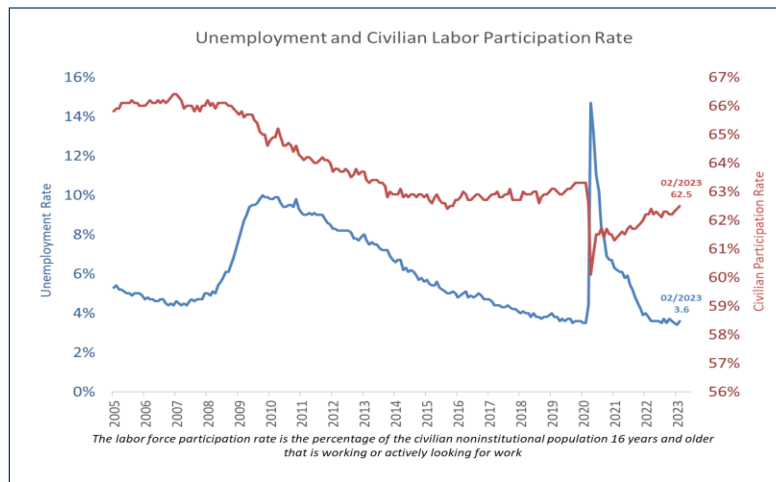
The nationwide shutdown changed the way corporations operated. Work from home (“WFH”) policies emerged and millions of people realized that what they did at the office could be conducted at home thanks to information technology. Many CEOs have articulated that after all this time, their employees are more productive when working from home due to less strain from traveling and wasted time at the water cooler. Even though most WFH employees gained a few pounds they became less stressed and more focused on getting their work done so they could spend more time with family. Also, companies such as Zoom provided the means to conduct meetings in any time zone for a relatively low additional cost.

Firms such as DoorDash and Instacart allowed people who were locked down to have their “night out” dinners delivered in addition to fulfilling their regular grocery shopping needs. (By the way, DoorDash was founded in Palo Alto in 2013 with the vision to be the local, on demand Fedex). More importantly, these entities prospered during the pandemic because people who had more independence were willing to work on their own time schedules due to the flexibility afforded by working from home. Both companies have grown remarkably fast and continue to thrive because their “employees” have improved our standards of living and quality of life.

Unfortunately, some companies skyrocketed and then collapsed along with the receding effects of the pandemic. Companies such as Peloton, the developer of stationary bikes that first began in 2013 and developed a cult-like following, flourished during the pandemic, and then floundered

as the surge in demand plummeted. After the 2021 boom came the 2022 bust with many of the "pandemic" companies' stocks falling by as much as 80-90%.

Selected economic statistics displayed in graphic form attest to the dramatic effect government policies had on the economy during and after the pandemic. The chart below reflects the unusual character of this period with the unemployment rate on the left axis and the participation rate on the right. What can be seen is the dramatic surge in the unemployment rate to almost 15% in 2020 on the back of government shutdowns.

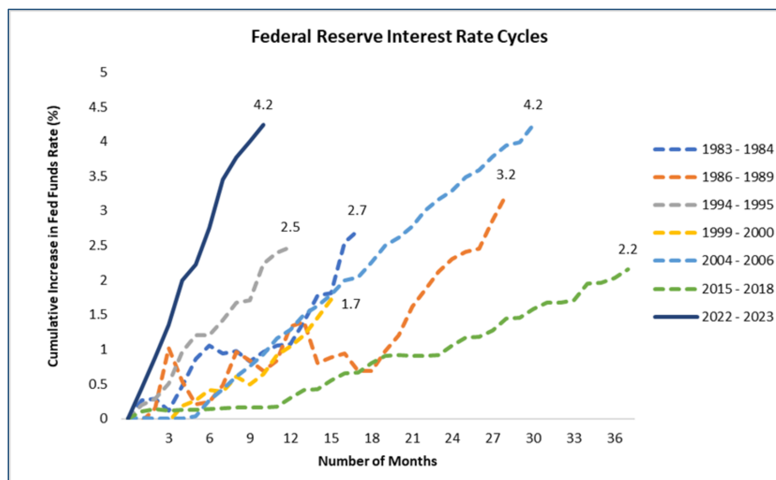


Once the government realized what was happening and stimulus and spending sprees were reduced, unemployment fell back to the levels that existed before the pandemic. By bringing employees back to work coupled with the jobs created because of the pandemic, the economy quickly got back on track. The Bureau of Labor Statistics tracks the labor participation rate as the percentage of the civilian noninstitutional population actively working or looking for work. The rate only considers those aged 16 or older as part of the labor pool. This measure of employment also continues to improve after declining dramatically during the pandemic.

The Downside of Fiscal and Monetary Stimulus

By early 2022, the economy was back on track. Another round of fiscal stimulus early in 2021 kept the economy going. Unfortunately, the combination of too much money and too little pandemic-related goods production led to a burst in inflation, the greatest since the 1980s. This surprise event changed the government's game plan for managing the economy. Initially the Fed interpreted this jump in inflation as a temporary or "transitory" phenomenon but after a few months of continued rising prices, the Fed changed course and committed to a higher interest rate policy. In the latter months of 2022 and early in this year, the Fed raised the federal funds rate faster than any time in recent history. For our regular readers, we wrote about this fact in our weekly Missive entitled "Unintended Consequences" published March 13th. The following chart reflects the record rise in the federal funds rate during 2022 and recent increases this year bring that rate up to a range of 4.75%-5.00%. Raising interest rates this quickly is one reason for the collapse of two banks and the mortgage rate shock undermining the homebuilding industry.

Stability in interest rates is critical to a smooth functioning economy. Let's look at an example of what such fluctuations in interest rates can do to an economy using a story by Jude Wanniski, an economist who compared such volatility to fluctuations in dimensions. He postulated what might happen to the construction of a home if the number of inches in a foot gradually changed on a daily or a weekly basis. Probably some very lopsided homes would be built! More likely, few would get built due to the uncertainty of the changing measurement.



When the Fed raised interest rates to slow the economy, interest rates on long term securities rose as well. The reason is that, in the secondary market, older, low yielding bonds had to compete with new bonds that sported higher coupons thus forcing the price of the older bonds lower. When the government poured money into the system, many recipients saved those freebies by making deposits in their bank accounts since CDs were looked upon as the safest of investments. Many corporations did the same thing.

The surge in customer deposits prompted banks to seek out better returns given the low interest rate environment. Regulations emanating from the financial crisis of 2008-2009 put limits on what banks could invest in and how these assets were accounted for on the balance sheet. As we know today, some banks opted to invest in long-term government bonds with higher yields to generate better returns. These banks could hold a portion of their long-term bond portfolio at par value without admitting to the rising interest rate environment. These long-term bonds should have had their values adjusted downwards in conjunction with higher interest rates. But they were not. Some analysist warned that a few banks were at risk of withdrawals, but to no avail.

In March of this year, the financial roof caved in on two banks that had opted to invest savings in long-term government bonds. There was a run by depositors on both banks and the FDIC (Federal Deposit Insurance Corporation, a government entity) stepped in to assure customers that their accounts would be made whole. What was unusual about this commitment was that the FDIC went beyond the $250,000 per account limit and effectively guaranteed all depositors whether they had $100,000 or billions of dollars in their accounts. The quick response by the regulators kept this banking crisis from getting out of hand, so far. This "run" spooked financial markets but by the end of March, the stock market had rallied substantially for the month and the bond market saw yields fall and prices rise. Financial markets reflected renewed confidence in

two things: regulators would stop at nothing to save the banking system and the financial maelstrom that lasted only a few days would dampen the Fed's willingness to continue to raise interest rates.

The irony of this situation is reflected in the fact that the Federal Reserve is intent upon raising interest rates to slow the economy, yet the current banking crisis is requiring the regulators to pour more money into the economy that could keep business on the upswing.

Conclusions

Financial markets rallied strongly during the first quarter of 2023 even in the face of a banking crisis and the continuation of the Ukraine war. The Federal Reserve maintained a tight monetary policy and continued to raise short term interest rates. Changes in leadership in the Congress have not had any measurable effect on the economy and forays into big spending or tax increases as proposed by the current Administration are not likely to pass nor affect the direction of the economy. Inflation continues to pull back from the record levels of 2021-2022 and continued low unemployment suggests that the economy is still on track for a good year in 2023. The latest forecast from the Federal Reserve Bank of Atlanta's GDPNow is for a first quarter gain of 2.2% even though other consensus estimates are lower. Other economic indicators reflect the prospect of an economic decline in the latter half of 2023 but given the performance of financial markets, we do not expect to see a downturn for more than one quarter towards the end of the year - due mainly to the Fed's policies.

Corporate earnings continue to reflect better times ahead for most industries. Many larger companies have laid off thousands of employees recognizing that the boom of 2020 was temporary. However, even with those layoffs, employment is still strong and real wages are rising. The Chinese economy is rebounding after the Covid lockdown, and this reopening will contribute to improved global economic growth. Most foreign markets continued to perform well through the end of the first quarter, suggesting that the world is not in as bad a shape as some forecasters expected.

Market prognosticators are mixed about what will happen to interest rates during the second quarter. Will the Fed relent on raising rates signaling an end to this tightening cycle or will it continue to pursue ever higher rates to contain inflation? Will the continued fall in inflation intimidate the Fed and usher in what has become known as a "pivot" or a reversal of Fed interest rate policy? Don't forget the Fed implemented such a pivot in early 2019 making for a positive return on financial assets. In either case, there doesn't seem to be a case for a continuation of a high interest rate policy for the balance of 2023.