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Research & Strategy Insights

US Policy-makers looking for a plan B

53 – 6 July 2020

Key points

- The impact on US activity of states delaying reopening or re-imposing restrictions is starting to show in some real-time data
- Discussions on a fiscal stimulus still focus on propping up household income now. This is a very costly and not necessarily very efficient. On the monetary policy side, the Fed seems to be thinking hard about "yield control"

The re-acceleration of the covid epidemic in the US is a month-old now, but last week for the first time some real-time data reflected a relapse in activity. This is still very mild and nowhere near the collapse seen in March and April, but in GDP weighted-terms 60% of the states have delayed their re-opening or rolled-back some relaxation of the containment measures. It is starting to show.

For several weeks we have been discussing this in combination with the speed and size of an additional policy stimulus. Indeed, financial markets seem ready to take some delay in the normalization of the largest economy of the world in their stride as long as more fiscal spending can promise a swifter rebound later. We need to look at the quality of the stimulus under discussion though.

The Democrats' HEROES Act worth USD 3tn (8% of GDP in 2020 and 6.7% next year) is ready and approved by the House. It seemed it was "dead on arrival" given the opposition of the Republicans in the Senate. However, last week President Trump said he could increase a second unconditional cash handout – HEROES' flagship measure – beyond what the Democrats proposed. We find the focus on household income quite puzzling. Indeed, the first stimulus is so large that in May income was already 3.8% higher than before the pandemic. The logic might be to pump up so much pent-up demand that consumption would recover faster than expected once restrictions are lifted. A drawback however is that if the reopening is delayed, the government will have spent trillions for very limited macroeconomic gain.

The Fed is thinking hard about a "plan B" if the economy fails to recover as quickly as hoped. The latest minutes suggest a lot of interest for yield control. We think it might be well suited to a central bank reluctant to engage in negative rate policy, while traditional QE may not be very efficient if the pre-set quantum of purchases is constantly dwarfed by even more sovereign issuance than expected. Through Philip Lane the ECB expressed its reluctance to contemplate this option. The ECB's "limits" may have struck again, even if for now the ECB is enjoying a rare respite, with good news on the European front of the pandemic and on the German Constitutional Court.

It’s starting to show

Continental Europe is starting to “look better” than the US, reversing the picture which prevailed in the spring. Indeed, output contraction in the Euro area was extreme from March to May as most of the member states – with the notable exception of Germany – opted for stringent lockdowns. The GDP growth gap in Q1 (it fell by 1.3% quarter-on-quarter in the US “only” versus 3.6% in the Euro area) is likely to be repeated in Q2, but the Q3 rebound looks more assured in Europe, as the pandemic continues to be in much better control than in the US (Exhibits 1 & 2).

Exhibit 1 – As steep as in March in the US

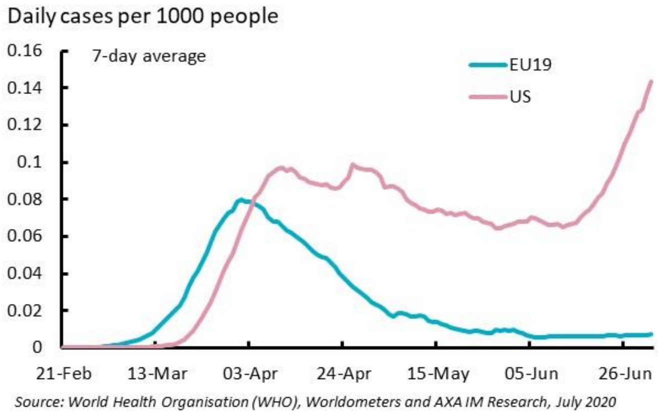
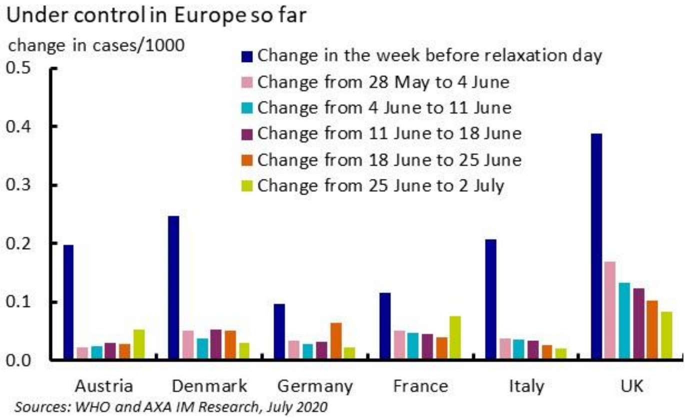


Exhibit 2 – Still under control in Europe



When controlling for the weight in US GDP, 60% of the states have by now paused their re-opening or rolled back on some relaxation measures (Exhibit 3). Containment measures remain mild and much more conducive to the continuation of economic activity than at the peak of the lockdown in Europe, but the impact is starting to show. Judging by Google mobility reports, Texas was leading the pack on resuming activity in late May and early June, exceeding the national average. It has started to relapse in the last two weeks (Exhibit 4), and so have Florida and California, albeit to a lesser extent. This is nowhere near the collapse seen in the early spring, but still visible.

Exhibit 3 – The “great Reversal” is underway

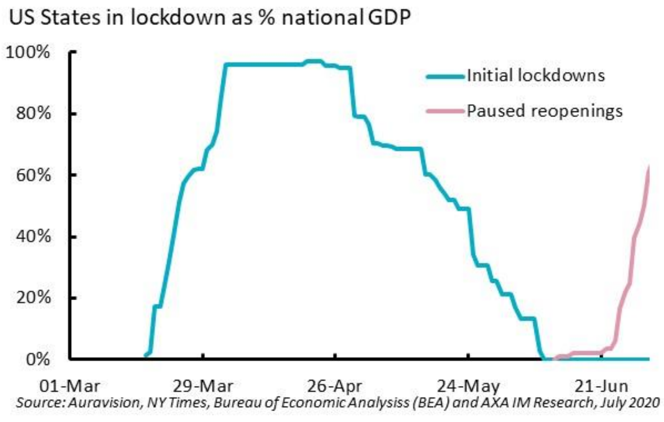
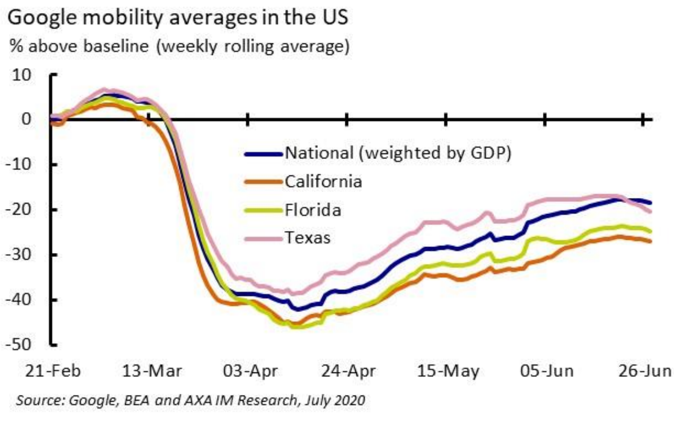


Exhibit 4 – Relapsing showing in real-time data



Still focusing on Google indicators, **Germany has been outperforming the US for several months now – in terms of distance from trend – but the latest development is that France has caught up with the US as well**, with Italy not far behind (Exhibit 5). We cross-check the message from Google with the Apple mobility reports, given their relative “freshness” (they come out two to three days earlier), making up for their lack of precision. On a seven-day rolling average basis, averaging their three components (driving, transit, walking), the US relapse is not yet visible, but France has decisively joined Germany above the US, with Italy a bit further away than with the Google data but also catching up quickly over the last three weeks (Exhibit 6). Note the reference: Google calculates the distance from trend, Apple from the mid-January level. It is thus not easy to translate this data into quarterly GDP growth. But in terms of momentum, continental Europe is at the moment doing better than the US.

Exhibit 5 – France joining Germany above the US

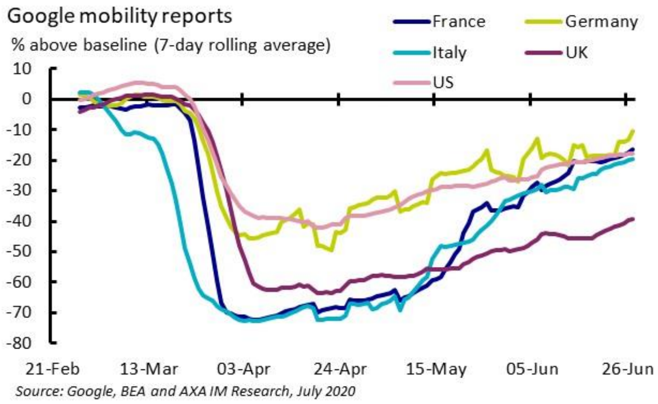
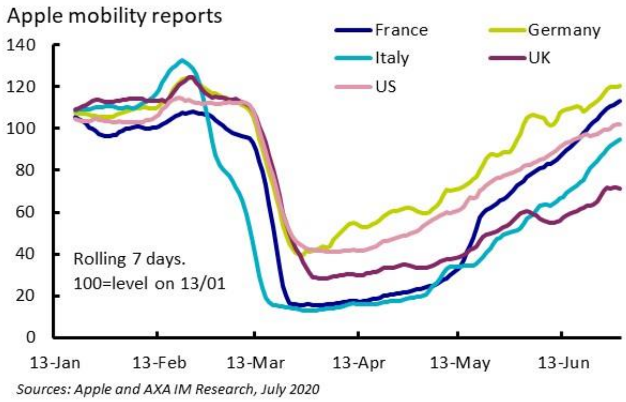
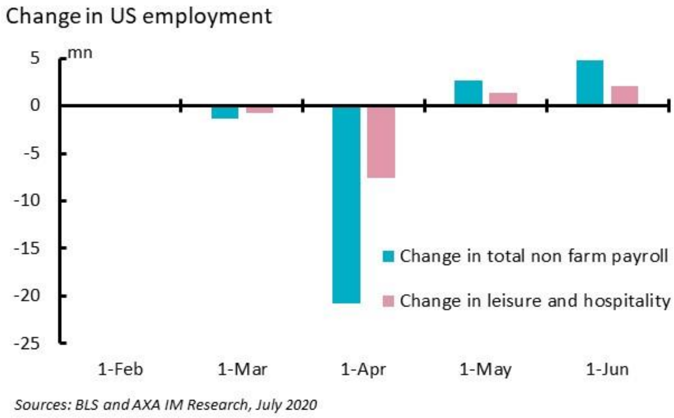


Exhibit 6 – Clearer with the Apple measure



Cyclical developments are going to be difficult to read in the coming weeks since the "traditional" economic data will for a while reflect the state of the US economy *before* the re-acceleration of the pandemic there. The June payroll data provides a perfect example of this. This was the second better-than-expected reading in a row, with non-farms jobs rising by 4.8mn in June (3.8mn expected), allowing for another decline in the unemployment rate (11.1% from 13.3%, versus 12.5% expected). It seems though that the driving force behind this good performance of the US labour market continues to be the pace of re-opening of the economy rather than any underlying strength. The recreation and hospitality industry, which in normal times accounts for just 11% of the US headcount, contributed 2.1mn (44%) to total job creation in June (Exhibit 7), as restaurants, bars and cultural venues were re-opening across most of the country at cut-off date for data collection (12 June). This suggests that the next month is not going to be as stellar, with the ongoing roll-back in some states affecting the re-hiring process.

Exhibit 7 – Major contribution from one sector



Of course, **the fact that re-hiring *was* happening at a very fast clip in May and the first half of June can be seen as a demonstration of the solidity of the US labour market.** We expressed concerns in Macrocast that the US could be left with more long term-scarring than Europe on the employment front since policies there do not focus on keeping workers legally attached to their employers, as they do on this side of the pond through powerful part-time unemployment schemes. Still, re-hiring is swift because the US labour market is much less rigid than in Europe, **with the side-effect that it is also more sensitive to cyclical gyrations. If activity slows down in Q3 on account of the pandemic relapse, job creation will fall significantly**.

It is a very noisy series, but the fact that initial jobless numbers for the week to 27 June (two weeks after the cut-off date for the June payroll) came out above expectations and barely declined from the previous week may be a "warning shot".

Is pumping up more pent-up demand the solution?

The Democrats in the House have passed in May a USD3tn "Health and Economic Recovery Omnibus Emergency Solutions" Act (HEROES), even larger than the ongoing CARES act (USD2.4tn). According to the Congress Budgetary

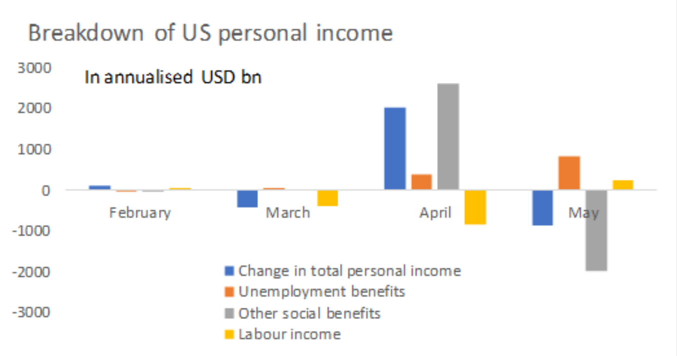
Office (CBO), the House's project would raise the federal deficit by no less than 8% of GDP in 2020 and 6.7% in 2021. The flagship measure in the package would be another blanket, unconditional "check" to US households, more generous than the first one which offered USD1,200 per adult plus USD500 per child under the age of 17, since this time dependents would also get USD1,200. A family of four would thus get USD4,800, instead of 3,400 in the first round.

The second serving of cash transfer is the most frequently discussed item, but it is only a fraction of the package which also legislates for, among many other things, an extension of the federal unemployment top-up by six months – i.e. bringing it to the end of January 2021 – and student debt relief. The Republican Senate Majority leader Mitch McConnell initially reacted to the plan by stating that this was *"an unserious product from an unserious majority."* The second check to households is unsurprisingly popular though, and President Trump stated last Wednesday that he was contemplating increasing it *beyond* the Democrats' proposal. In a nutshell, **the HEROES act is unlikely to go through the Senate in its current form, but it is however likely that another thick layer of fiscal stimulus will be agreed by the Republicans.** The negotiations between the House and the Senate are likely to resume on 20 July, with a potential conclusion by 7 August when Congress adjourns.

The focus on household income is quite surprising. We have already made the point in Macrocast that, while automatic stabilisers tend to be smaller in the US than in Europe, which explains why American policy-makers need to implement more discretionary measures, **the current "carpet bombing" is to some extent overkill**. In April, gross disposable income *rose* by a whopping 10.8% month-on-month. Labour income fell by 7.4% (USD1.15tn), but this was more than offset by the steep rise in unemployment benefits (USD0.45tn) and "other benefits" – mainly the first federal check – to the tune of USD2.5tn. With the impact of the "check" disappearing, personal income relapsed in May (-4.2% month-on-month) but thanks to the generous federal top-up to the unemployment benefits, it is still 3.8% *above* the pre-pandemic level of February (Exhibit 8).

While it seems that many Americans have slipped through the net and find themselves in a precarious position, *aggregate* numbers still reflect a very comfortable position: while businesses bankruptcies have started to rise (filings under the "chapter 11" process have hit their highest levels in two years in May 2020), **personal bankruptcies in April and May 2020 hit their lowest level since records started in 2006 in their current form.**

Exhibit 8 – Fiscal support of US income in overkill



Sources: BEA, AXA IM Research, July 2020

It is not obvious to understand the logic behind the US fiscal approach so far. This is possibly because the ongoing fiscal stimulus is the chance result of Democrats pushing in the House, combined with the effort of Republicans in the White House and the Senate rather than a carefully-crafted coherent response. In a potential rationalisation, the idea might be to "pump up" such a massive pent-up demand that the US will experience a much faster-than-expected catch-up upon re-opening, lifting animal spirits and providing enough momentum to overcome the negative impact of lingering virus-related uncertainty to propel the economy in a lasting V-shape recovery. **Of course, if the re-opening is delayed or muted, such strategy would ultimately be very costly: the federal government will have spent trillions of dollars at the wrong time and will be forced to maintain its emergency support well into the second half of 2020 to get the same effect on annual GDP.** We would gladly exchange less emergency support now for more long-haul stimulus later – in particular in the form of public investment as we argued last week. We might get both, but then the deficits which are already ballooning will take another turn for the worse.

A key issue to gauge the ramifications of the current economic developments in the US for the global economy is how the ongoing relapse will affect President Trump's electoral strategy. Polls are increasingly concerning for his re-election prospects, and historically the state of the economy, and specifically labour market prospects, has been a very good predictor of the electoral fate of incumbent US Presidents. Just like in 2016, President Trump's rhetoric can be assessed along two axes: one is the "cultural" line – the stance of race relations and immigration – the other is the economic line – the stance on protectionism. So far, and again very clearly so in his speech for the 4th of July, Donald Trump has been much more vocal on the first axis than on the second one. A risk of course in terms of market volatility is that this changes as the election looms.

The Fed is looking for a plan B

Delayed re-opening is not just a challenge for fiscal policy. The Federal Reserve (Fed) would be under a lot of pressure to deliver more should the expected V-shape recovery fail to materialise this summer. The minutes of the June Federal Open Market Committee (FOMC) meeting released last week suggest the US central bank is far from complacent despite the "shock and awe" strategy it has deployed since March. The minutes start with quite a bit of introspection, with two staff briefings on first the impact of combining quantitative easing with forward guidance and second on the pros and cons of shifting to an explicit "yield control" approach. Interestingly, there was no mention of embarking on a negative policy rate stance, confirming the lack of appetite in the US for this approach.

Combined forward guidance with quantitative easing (QE) is a tried and tested strategy for the Fed, but the staff briefing did not convey much confidence on its chances of success in the current configuration: *"The simulations suggested that the Committee would have to maintain highly accommodative financial conditions for many years to quicken meaningfully the recovery from the current severe downturn (…) businesses and households might not be as forward looking as assumed in the model simulations, which could reduce the effectiveness of policies*".

It is not surprising thus that the Fed seems open to explore alternative solutions, and "yield curve control" or to be more precise "yields caps or targets" (YCT) as the staff prefers to call it, is a natural candidate. In the run-of-the-mill QE, the central bank sets an explicit quantum of asset purchases and the risk-free interest rate across the curve is the result of how this quantum changes the demand and supply equilibrium on the market. In YCT, the central bank sets a target for the "market" interest rate on one or several points of the yield curve, and the quantum of purchases is whatever is needed to achieve this target. In other words, in YCT the central bank is no longer in control of the size of its balance sheet.

Yield control could be well suited to a situation in which the central bank is up against a limit on its own policy rate and fiscal deficits are ever-expanding. Indeed, if the Fed does not want to contemplate taking Fed Fund rates in negative territory – which normally "trickles up" the yield curve – while the impact of traditional QE on the yield curve is muted since the pre-set purchase quantum is constantly dwarfed by more sovereign issuance, then direct price intervention across the curve is needed to make sure financial conditions can be loosened further.

The briefing to the FOMC, looking into the current Japanese and Australian experiences as well as the Fed's own YCTs during World War II and afterwards was cautiously supportive: *"these three experiences suggested that credible YCT policies can control government bond yields, pass through to private rates, and, in the absence of exit considerations, may not require large central bank purchases of government debt*". Still, the briefing also highlighted that *"under YCT policies, monetary policy goals might come in conflict with public debt management goals, which could pose risks to the independence of the central bank*".

The reaction of the majority of FOMC members, judging by the Minutes, is that as long as the current stance on forward guidance remains credible, there is no compelling reason to move to YCT, but it also seems that most minds are open to such eventuality. Such a shift could easily happen in our view if the committee were to consider that financial conditions are no longer appropriate, for instance in a situation in which a worsening of the economic situation in the coming months was not accompanied by a further reduction in long term interest rates.

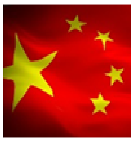
The ECB is having a respite but the fundamental issues are still there

European Central Bank (ECB) Chief Economist Philip Lane in his latest interview to Reuters last week was asked about yield control. It would always be more complicated for the ECB, given the absence of a unified bond market. Still, one could imagine a set-up in which the central bank would target a specific level for the de facto reference risk-free long-term interest rate (the 10-year Bund) while explicitly announcing the maximum spread it would tolerate in other jurisdictions. Philip Lane dismissed the idea in no uncertain terms*: "we are not, absolutely not, into yield-targeting or yield-curve control, that's not part of what we're doing… You can only target the yield if you promise to buy everything, which we do not*".

Philip Lane implicitly highlights a key difference between the ECB and the Fed. **The US central could expand as far as needed its intervention on the sovereign bond market, while the ECB cannot cross certain limit**s without finding itself in breach of the EU Treaty on monetary financing of governments. This limit may be 50% - as might be construed from the European Court of Justice decision on the Public Sector Purchase Programme – or 33% – as the German Constitutional Court seems to be believe, that much is uncertain, but that there are limits is not.

This is where the ECB again finds itself in a very ambiguous position. Philip Lane rejects the assumption the central bank is engaging in YCT, but also maintains that the ECB would lean against "*one-sided markets*", where "*overshooting*" occurs, and spreads become explosive. Still, while the ECB professes not to have *"any particular view on the level of the spread*", in order to detect overshooting, the central bank must have an opinion on what the "right" spread should be. And in any case, at some point it may have to spend whatever is needed to stop such overshooting. **So, in our view the difference between the ECB's practice these last few weeks and YCT is mostly that the Governing Council does not provide an explicit target. But one could derive an implicit one from the changes in the pace of buying.** Still, at some point the question of the "limits" will come back and the central bank cannot afford to have an explicit debate on yield control if it does not solve this issue for good**.**

For now, the ECB is having a rare respite. The Bundestag has endorsed the proportionality of the ECB action on PSPP which is one key step towards resolving the conflict with the German Constitutional Court (even if we still consider it problematic that we had a national parliament opine on a monetary policy decision of the independent central bank). It seems a political agreement will be found this month on the Commission's Recovery and Resilience Plan, even if we think it will take time for the operational details to be hammered out. But should the world economy fail to improve in the second half of the year as swiftly as expected, the central bank will be called again to provide more support. Its constraints have loosened, not disappeared.

Country/Region	What we focused on last week	What we will focus on this week
	• US daily increases in virus set new records, more states reverse/pause re-openings • June's payroll report saw 4.8mn job gains and unemployment fell to 11.1%, although scale of genuine joblessness contested. • FOMC minutes suggest Fed to use forward guidance, not yield controls going forwards	• Pace of virus gains across the US • US ISM non-manufacturing index for June, watch for similar gain to manufacturing • Weekly jobless claims watched for renewed deterioration as reopenings pause • PPI inflation for June
	• May consumer spending rebounded sharply in France (+37%mom), while German retail sales far exceeded expectations (+14%mom) • EA unemployment rate only edged up 0.1pp to 7.4%mom in May, reflecting short-time work scheme • June EA core inflation dropped to 0.8%yoy	• Fitch review of Italy's BBB- stable rating, we expect the agency to wait for government's 2021 budget plan before taking a decision • May industrial production data to show double digit growth • Following the resignation of the French PM, government reshuffle to be announced
	• UK Q1 GDP revsed down to -2.2%qoq (from -2.0%), saving ratio rises to 8.6% • BoE's Haldane "so far, so V recovery" – BoE outlook improves from bleak May Report • PM Johnson speech announces accelerated spend of £5bn on infrastructure • Annual house price falls - first since 2012	• Chancellor Sunak addresses Parliament, expected to announce further measures to support economy • Brexit talks continue after EU suggests signs of compromise • UK RICS housing survey, price balance to rise from deeply negative territory
	• June final PMIs are mixed with manuf sector slowly improving to 40.1 from 37.8 while services rebounded (45 from 26.5) • Unemployment rate rose to 2.9% (+0.3pp); jobs/applicants ratio fell to 1.2 from 1.32. • Q2 Tankan for big manufacturers fell to -34 • June consumer confidence is up 28.4 from 24	• May household spending • June bank lending is expected to remain at high levels (May: +4.8%yoy) • The Economy Watchers poll should point to a stronger rebound • May machinery orders are likely to remain weak (around -5%mom)
	• PMIs surprised on the upside, suggesting continued recovery momentum • PBoC cuts re-lending and rediscount rates by 25bps	• Inflation pressure should continue to ease, although food disinflation may ease due to floods in south China
	• Poland: first round of general election sees President Duda (PiS, far-right) facing Warsaw Mayor Trzaskowski (PO, centre-right) in run-off vote. Russia: amendment to the Constitution allowing President Putin to rule until 2036 successfully voted. • PMIs improved in June across EM except for Mexico (deteriorating business conditions).	• Central Bank meetings: Malaysia, Peru. • Czech Republic Industrial Production (May) and Unemployment Rate (June). Brazil Retail Sales (May) and Inflation (June). Russia Inflation (June).

Upcoming events	US:	Mon: non mfg ISM, final services PMI; Tue: JOLTS, Treasury report; Wed: mortgage apps, index, consumer credit; Thu: jobless claims; Fri: PPI, core PPI
	Euro Area:	Mon: Ge mfg orders, Sp industrial production (IP); Tue: Ge IP; Wed: Bank of France industrial sentiment; Thu: Eurogroup meeting, Ge trade; Fri: Ecofin meeting, Fr IP, It Fitch review
	UK:	Mon: construction PMI; Tue: Halifax house prices, labour productivity; Wed: MPC Treasury Committee hearings, Chancellor statement to parliament; Thu: RICS house prices
	Japan:	Tue: household spending, leading index; Wed: bank lending, Economy Watchers current index; Thu: core machinery orders, M3 money supply
	China:	Tue: FX reserves; Thu: CPI, PPI

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