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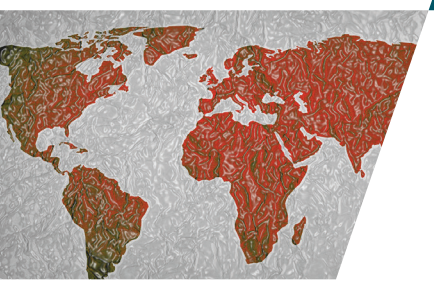

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# Comparing Two Market Crises:
## A New Type of Crisis Requires a New Solution

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The Global Financial Crisis of 2008 was a gigantic worldwide liquidity crisis that morphed into a recession but was largely treatable by monetary policy with fiscal support. Novel monetary and fiscal solutions, Quantitative Easing (QE) and the Targeted Asset Repurchase Program (TARP) in particular were put into place in the U.S.

QE was used initially to solve the overwhelming illiquidity issue of the moment. No free market solution would have worked without untold misery of unemployment and bankruptcies. The banking system could not have survived. Our federal government purchased certain assets that were killing private sector holders because of their illiquidity and placed those securities on a balance sheet that possessed an infinite maturity—that of the federal government. These policies worked, and the U.S. taxpayer even made a profit on TARP holdings.

In my 50 years of working in finance, it was the most terrifying moment I had ever experienced. The world as we knew it could have imploded. But it did not thanks to the mixture of TARP and QE. (See our white paper "The Financial Crisis: A 'Whodunit' Perspective" on our website for a more complete history.)

The COVID-19 pandemic of 2020 is a very different situation. From an economic perspective, we are facing a huge demand shock, not a financial liquidity shock. Without an offset, we will then face a supply shock as unemployment rises and productive measures crumble. This important difference from 2008 must be solved with fiscal policy and not monetary policy. The latter cannot address the problem we face today. For one thing it comes at a time when corporate balance sheets are highly leveraged relative to their past and the global manufacturing base was already flirting with recession as reflected in global manufacturing PMIs.

COVID-19 has produced a huge demand shock at the same time in which we have entered a new cold war with China, supply chains are being deglobalized, and the labor arbitrage that began with the fall of the Berlin Wall in 1989 has run its course. Profit margins were peaking, manufacturing PMIs were falling and corporate debt leverage was touching new highs.

As we begin to grasp both the human and economic consequences of this pandemic, the demand shock is increasingly evident. A recession is inevitable when one considers the forces in motion and only fiscal policy can address the broadening consequences of this exploding demand shock.

Think of COVID-19 as a point on an "S" curve. Early on, the incidence of the virus expands as it rides up the S curve. Every data point is higher and the rate of change is increasing as well. At some level, we reach an inflection point. After that, the curve continues to rise but at a decreasing rate before it reaches an asymptotic state (think flat).

We still do not have a good picture of where we are on the "S" curve globally. China and South Korea appear to have passed the inflection point but that does not appear

to be the case elsewhere. The key is to hit the inflection point as soon as possible and hope that we can bend the curve to something close to flat. Think of the letter "L" upside down. Achieving that will require significant social distancing now and eventually a vaccine.

The faster we flatten the line, the better for our health, but actions taken to do just that will worsen the economic outlook. This is why we need fiscal stimulus, and it will have to be big. Only the federal government can deal with this problem in order to minimize the length of any economic slowdown. We must offset the demand shock arising from the "treatments" (primarily social distancing policies) required to eliminate the virus.

Consider the following model. It is something we have used in the past to demonstrate the linkage between the real economy and the financial economy. The links between the two economies are shown below.

Real GDP is the sum of the levels of employment and productivity. The growth rate is the sum of the growth rate of the work force plus the growth rate of productivity. Add inflation to that number and you have nominal GDP.

If one holds profit margins constant, the growth rate of nominal GDP tends to equal the growth in corporate earnings over long periods of time. The valuation metric for those earnings (think P/E) is largely driven by the inflation rate as reflected through interest rates. The absence of inflation would cause one to use what economists call a "normal" interest rate.

Here is where a lot of things changed during the last decade. QE dropped or even eliminated the "normal" rate, causing the present value of financial assets to soar. The idea was that the higher level of financial asset values would induce higher GDP because higher wealth combined with the marginal propensity to consume (MPC) would accelerate growth in employment and productivity and lead to overall GDP growth accelerating. While it was helpful to the economy, even if not to the degree that was hoped for, it was fabulous for financial asset valuations.

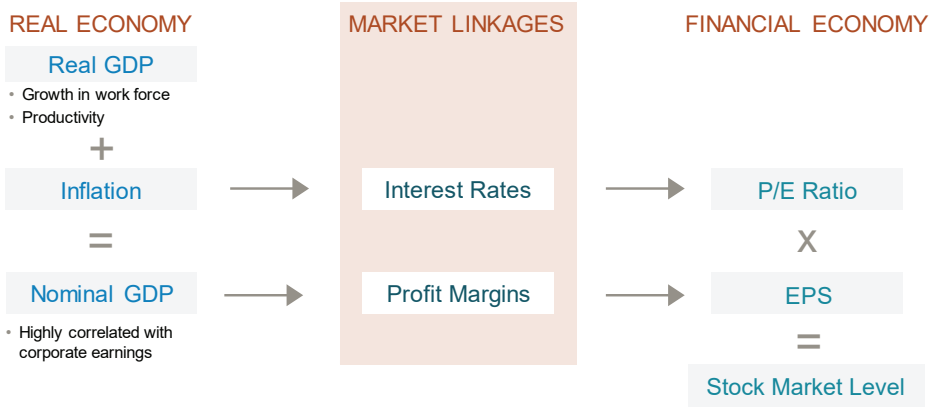
Now, let's look at the model through the lens of the demand shock induced by COVID-19. Services represent more than 50% of the U.S. economy, and services require human interaction. Social distancing will impair that activity and eventually result in lower employment and productivity. As these components decline, so will real GDP, leading inevitably to a recession.

Monetary policy cannot address this problem, but fiscal policy can. The "G" component in the C + I + G + (X-M) = GNP equation must be expanded a great deal. Only fiscal policy can accomplish this end. For the U.S., a badly needed infrastructure stimulus could be put into place. With Treasury rates at all-time lows, it would be easy to finance. (Yes, we would be adding to the "debt mountain," but let's hold that issue for the moment.) There are two big sources of demand for the debt issuance: foreigners and the Social Security System regardless of the low rate levels that exist at the moment. (That argument will be presented in a future paper).

If the only tool we use is monetary policy it will fail badly. The demand shock will lead to a supply shock as unemployment rises and productivity falls. One must use fiscal policy to solve this problem even if it means mailing a check to households every month who are suddenly left without income earners because of the shock emanating from the social distancing policies required to defeat biological effects of the virus.

The Fed has cut rates to zero, but it will not be enough. If fiscal policy is deployed in a timely (now) and efficient manner, the future shape of the economy can look more like the letter "V" than the letters "U" or "L." The equity markets will reflect that shape as well.

**FIGURE 1: Financial Economy Linked to the Real Economy**




*Source: Crestmont Research; Epoch Investment Partners, Inc.*