A Massive Cash Injection

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It has been over six months since the United States experienced the most severe economic slowdown since the Great Depression, and while the nation's economy seemed to be near the precipice of disaster, today things *appear* to be much improved, at least in the stock market, which has recovered to pre-pandemic levels. The rebound in the stock market has caused many to wonder, How can Wall Street be doing so well while Main Street is still struggling?

As we wrote in our summer newsletter, with consumers living in quarantine and many businesses shuttered, consumer behavior shifted away from relying on traditional brick and mortar businesses toward using online companies. When we look at the economic slowdown caused by the coronavirus pandemic, it is obvious that the negative impact was disproportionate across the economy, especially when comparing most large companies with small "main street" businesses, which were hit much harder.

Adding to the difficulties of many small businesses was the fact that the economic slowdown was quite abrupt, forcing many small "non-essential" businesses to close, while many larger companies were deemed essential and could stay open, or were able to operate remotely. The shuttering of businesses caused the nation's economic growth (as measured by the gross domestic product) to fall 31.4% during the second quarter, the steepest decline since first recorded in 1948. With many workers furloughed, working remotely or laid off, investors were fearful that the unemployment number would rise in the following weeks. This concern was validated when the U.S. unemployment rate jumped from 3.5% in February to 14.7% in April. In September, the overall U.S. unemployment number went down to 7.9%, signaling further improvement in the economy. Parsing this data a little further, we can see that the pandemic has disproportionately affected various sectors of the economy: unemployment in the leisure and hospitality sector was 19%, while the education, government and financial sectors were all at or below 5.1%.

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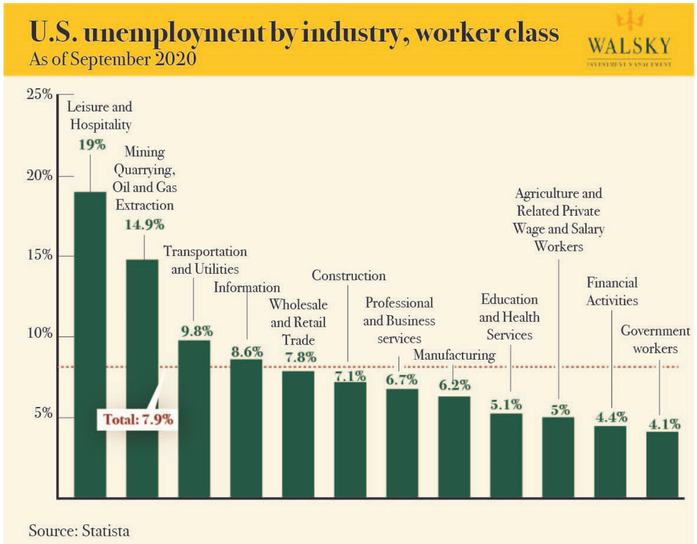
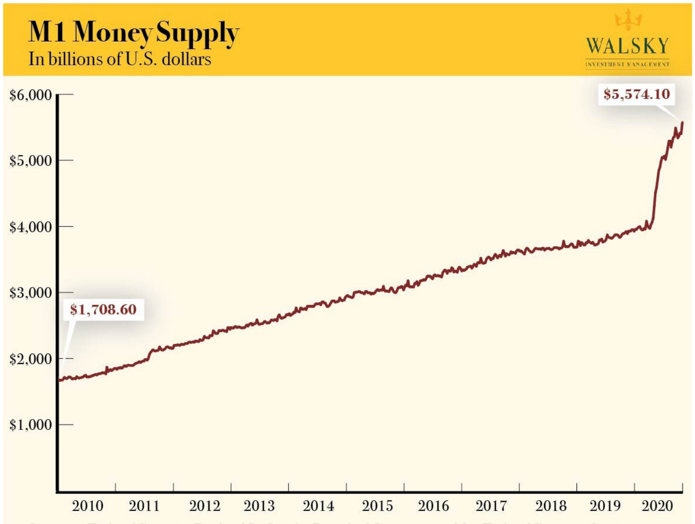


While the economic slowdown may have disproportionately affected companies based on their size or industry, the overall impact was severe. During the early weeks of the pandemic (in March and April), many investors feared that the financial problems of businesses most affected by the pandemic would have a domino effect on the bond market and cause a credit freeze, similar to what happened during the 2008 housing crisis. When that credit freeze occurred, even the best companies found it difficult to borrow.

It was with 2008 in mind that the Federal Reserve and the Treasury Department, led by Chairman Jerome Powell and Secretary Steven Mnuchin, quickly created a program to ensure the normal operation of credit markets, where companies and investors buy and sell bonds and other debt instruments. These debt markets provide necessary liquidity (cash) to governments and large businesses for their normal operations, as most banks simply cannot lend enough to meet their needs.

The plan they created was to have the Federal Reserve implement emergency lending authority, which allowed them to set up special programs to buy debt from and extend loans to businesses large and small by using new monies from the Treasury Department, thereby putting more money into the economy. The effect of this plan can be seen in the chart below, as the money supply (M1) in the U.S. increased nearly 40% from February 24 to September 14, 2020. M1 measures the amount of currency, coinage, demand deposits, traveler's checks and other "checkable deposits."

What the plan accomplished was to enable businesses that were most affected by the pandemic such as airlines, hotels and cruise ship operators, to borrow needed monies. A caveat of the lending program was that companies that borrowed directly from the Fed would not be allowed to pay dividends or buy back their own shares. The lending programs included the Paycheck Protection Program (PPP), the Coronavirus Aid, Relief, and Economic Security (CARES) Act and several others that provided needed support to employers of all sizes and communities across the country.



Since the plan stabilized the open market for bonds and the issuance of debt, it also allowed companies that did not need to borrow from the Fed to continue paying dividends to their shareholders and not be forced to cut their dividends in order to preserve cash. It is remarkable to see how our clients' dividend income has grown during this period. As we have written in previous newsletters, there is a correlation between dividend growth and market return. Dividends remaining intact helped investor confidence grow.

Another outcome of this program was that the massive influx of money into the economy helped drive down interest rates. From February 26 to March 25, the 1-month U.S. Treasury bond rate fell from 1.6% to 0.0%. With interest rates hitting new lows, stocks became more attractive to investors.

When the stock market was clearly recovering in early summer (while many businesses were still struggling), some would claim that the plan created by the Treasury Department and the Federal Reserve helped Wall Street and not Main Street. Clearly the program contributed to the rebound in the stock market; however, it also enabled businesses that were suffering to keep paying their workers and stabilize the economy during its darkest hours. Furthermore, the success of this program has motivated Congress and the White House to negotiate another $2 trillion of economic relief. The purpose of the latest package is to provide additional support to those who are still struggling on Main Street.