Market Commentary

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Employment Data Collapses and the Fed Stiff-Arms Negative Rates

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April's 20.5 million drop in employment was as dreadful as it was heartbreaking. Unfortunately, the post-war record-high 14.7% U3 Unemployment Rate was probably understated. In its release, the Bureau of Labor Statistics (BLS) stated if workers classified as "employed - absent from work" were captured as "unemployed - on temporary layoff" the U3 rate would have been 5% higher. Semantics. For what it's worth, 19.7% seems closer to reality, and I would be very careful using "temporary".

Regardless, I'd argue we learned virtually nothing about the outlook for the economy or markets from the BLS release, or basically any economic print since February. The economy is bad and current numbers are just confirming what we all see. Which doesn't mean upcoming releases should be ignored. We are now past the first wave of post-shutdown numbers; the next step is to watch for the bottom or basically when the data stops getting worse. The best real-time indicator right now is Initial Jobless Claims which posted another 2.981 million in new filers on Thursday, a mere 195,000 decline from the previous week which can hardly be called progress.

Fed Chairman Powell spoke at a virtual conference on Wednesday and painted a grim outlook for the economy. He succinctly summed up his views with this observation, "This reversal of economic fortune has caused a level of pain that is hard to capture in words." It's hard to disagree. While pledging to bring all the Fed's powers to bear on the economy and markets, Mr. Powell suggested the most effective response may need to be on the fiscal side. He acknowledged the costs could be great, but worth it if it helps avoid long-term economic damage and leaves the U.S. with a stronger recovery.

One of the tools the Fed will not be using, for now, is negative interest rate policies (NIRP). When asked during the Q&A session, Mr. Powell said the Fed's views on negative rates have not changed and is "not something that we're looking at." The efforts to downplay NIRP as a policy tool seemed to be a concerted effort. On Monday, Fed Presidents Evans and Bostic said they did not see negative rates being used in the U.S. and Cleveland Fed President Mester followed up Mr. Powell by suggesting the same. We have a dim view of negative rates for multiple reasons beyond our desire to provide investors with positive yields, including:

- Long-term negative yield policies in Japan and Europe have done little to spark growth in those economies.
- Negative rates hurt bank profitability, inhibiting capital formation and, in turn, the ability to extend credit. Banks are the key transmission mechanism for monetary policy and it hardly seems wise to lower their incentives to lend.
- The Fed has more effective tools to lower corporate credit spreads than NIRP, including recently announced corporate credit facilities set to go active in May.
- Negative rates introduce operational challenges for the Fed, banks and money market funds. Figuring out how to charge investors for deposits will take critical time, focus and resources away from the business of digging the economy out of an immense hole. Who needs the distraction?

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- Risk-averse consumers may not react to negative rates the way advocates predict. My guess is if charged rather than paid interest to hold cash, savers will seek to hoard more cash rather than spend it, rightly thinking they will need resources to plug the income hole in their budgets. Also, incenting investors to take on risk in a reach for yield seems misguided and would create a new set of problems in the next market downturn.
- Finally, negative rates would be a disastrous policy for the U.S., not just economically but socially. Think of the messaging, "We need to confiscate 2% from your savings accounts every year to make sure large companies can refinance leveraged balance sheets and not go bankrupt. But hey, it will help some of you keep your jobs." Count me out on working in the Fed's PR department.

Mr. Powell was definitive in rejecting NIRP. But don't expect the issue to go away. Investors have pushed early 2021 fed funds futures into negative territory, just by a basis point or two, but enough to grab headlines. President Trump is unlikely to abandon his crusade for negative rates and he has credentialled allies in former Fed President Kocherlakota and Harvard economics professor Rogoff. Our base case is the Fed will not pull the trigger on negative rates, but the central bank has bent to market demands before and Mr. Powell's stand will surely be challenged again.

Sources

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