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## Can Wall Street Remain Resilient to the COVID-19 Surge?

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By Tim Duy    Thu, Jul 16, 2020

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*'The next round of shutdowns will be limited to a small part of the economy, so we won't see the collapse in spending that we saw earlier in the crisis,' predicts our guest columnist, an economist at the University of Oregon.*

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As we move deeper into the second half of the year, we face three big questions. To what extent does the renewed surge in COVID-19 cases slow the economic recovery from the first-wave of shutdowns? How much fiscal stimulus will Congress deliver? What will the Fed do to support the recovery?

There are no easy answers to the first question. Virus numbers are surging across the south and west, but will we see a return to stay-at-home orders or more modest interventions? My instinct is that we will see a mixed strategy of wearing masks coupled with sector-specific shutdowns such as the closure of bars in Texas, capacity reductions for restaurants, and the shutting of fitness centers. With continued fiscal support, the economy could weather such a storm. To be sure, growth will be slower than desirable in the near-term, but longer-term growth requires controlling the virus.

How much would this impact Wall Street? In the category of “things that will make people unhappy,” leisure and hospitality is the icing on the cake in the economy. Even though the sector has grown in importance in recent years, it’s valued-added was only 4.2% of GDP going into the crisis. The economy can transition away from a shock to this sector.

The key is not to allow that transition to translate into cascading shocks to the financial system, as occurred after the burst of the housing bubble. That’s where fiscal and monetary policy can continue to help. Barring such a major meltdown, I suspect the rally on Wall Street can survive without keeping the bars open.

Given the deteriorating conditions in some states and resulting political impact to Republicans, my expectation is that we see a fiscal support package in excess of the \$1 trillion (maximum) the White House wants but less than the \$3 trillion passed by the House. A key element of any package is that some form of enhanced unemployment benefits will continue, although not with the \$600 weekly add-on as before.

Treasury Secretary Steven Mnuchin said on CNBC that the White House wants to change rather than extend the enhanced unemployment provision. He did not give details on how it would want to structure aid to unemployed workers. "You can assume that it will be no more than 100%" of a worker's usual pay, Mnuchin said.

He echoed Republicans who argue the generous insurance deters some people from resuming work because they make more at home than they otherwise would at their jobs. This is a glass half-full sort of situation.

Realistically, the full additional \$600 a week wasn't going to last forever. From a market perspective though, a continuation of benefits at 100% for many workers would be supportive. More generally though, if you believe conditions will rapidly deteriorate in (formerly?) Republican strongholds in the next two weeks, I think you should expect the final numbers on the next pandemic response bill to climb higher. Yes, I understand this has the unpleasant implication that a worsening COVID-19 situation is a market positive.

The Fed will continue to lean toward easier policy. With unemployment expected to remain high and inflation low, the Fed will be under enormous pressure to take further action. Initially, I expect that to appear in the form of enhanced forward guidance and then eventually yield curve control.

There has been some notion of late that the Fed is deliberately moving in the opposite direction by withdrawing stimulus. This idea has gained some traction because the balance sheet has contracted a bit; repo operations have fallen to zero. I don't think you should interpret this as an intentional reduction of support by the Fed. It simply reflects better market functioning and more excess reserves such that the repo operations are no longer needed.

Three further points. First, the relationship between the Fed balance sheet and equity prices is murky at best. To the extent that the relationship appears, it is spurious. So I wouldn't bet that a reduction in the Fed balance sheet resulted in a sustained decrease in stock prices. We already did that experiment.

Second, the Fed is already committed to sustaining the current pace of asset purchases. To support the flow of credit to households and businesses over the coming months, the Federal Reserve will increase its holdings of Treasury securities and agency residential and commercial mortgage-backed securities at least at the current pace to sustain smooth market functioning, thereby fostering effective transmission of monetary policy to broader financial conditions.

Third, realistically if market conditions deteriorate, the Fed will accelerate asset purchases if they feel necessary. Which altogether gets to the old story of “don’t fight the Fed.”

Bottom Line: If I am cautious going forward, it’s because I am worried that rising Covid-19 cases could turn market sentiment negative. I also worry that another shutdown risks cascading problems in the financial sector.

I weigh those concerns, however, against my expectation that the next round of shutdowns will be more limited to sectors that are a fairly small part of the economy, that we will thus not see the general collapse in spending as we saw in the initial phase of the crisis, that we will likely get sufficient fiscal stimulus to limp along at worst, and the Fed will continue its efforts to support the recovery.

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