

# WHY A NIKE SWOOSH-LIKE recovery is more likely than a V-shaped bounce back



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Hamish Douglass, Chairman and Chief Investment Officer, caught up with Janet Yellen, the most recent former Chair of the US Federal Reserve, and an adviser to Magellan, about the current covid-19 health and economic crisis. The pair discuss the response of the Federal Reserve, the economic impact, the struggles of emerging markets and the risk of inflation.

**HAMISH** The Federal Reserve is being just as aggressive as it was in response to the global financial crisis. What is similar about this crisis to 2008-09? And what is different about this crisis?

**JANET** What's different about this crisis is that this downturn was induced by a non-economic shock, the pandemic. And that's different from 2008-09 or any other downturn that I can remember. The 2008-09 global financial crisis was induced by deep-seated problems in the economy and the financial sector; namely, incredible leverage in the banking system, a house-price bubble, rapid credit growth, weak underwriting standards and overindebted households. And that was a set of balance sheet problems that had to be worked off before the economy could recover. And that was a time-consuming process.

Now, if tomorrow a vaccine were invented, we all had it and the health risks were to end, the economy could largely go back to normal and the pre-pandemic situation when, even allowing for some challenges, the US economy was in good shape in a macroeconomic sense. But the health risks are unlikely to end quickly. And if they last a long time, as I expect, there's going to be a lot of scarring. Companies in the US started this crisis with a lot of debt and they're being forced to take on more. So it's going to be necessary for them to repair their balance sheets. There are likely to be significant corporate failures and that points to weak investment and employment heading into the recovery. Household finances are likely to suffer damage. They are going to need to restore financial buffers. The government has been doing a lot to support the economy. I hope some of that will continue. But the government too will end with a lot more debt and that will likely diminish future fiscal flexibility.

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**HAMISH** Janet, would you maybe explain in simple terms what the Fed has done in this crisis? What tools has it used?

**JANET** The Fed has acted quickly and forcefully and these steps fall into two categories: monetary policy and emergency lending. With monetary policy, the Fed quickly lowered the overnight short-term interest rate target, the Fed funds rate, effectively to zero and it

essentially promised that the rate would stay there for a long time. That's helped to bring down longer-term rates. The Fed also began essentially unlimited asset purchases. At first, these were oriented towards market functioning, which was highly impaired. But after about two weeks, starting in mid-March, the Fed bought almost US\$2 trillion worth of assets, Treasuries and mortgage-backed securities.

That's not a small amount of money. The Fed also reactivated swap lines with other central banks, something it did in 2008-09 because banks all over the world that do business in dollars found themselves under pressure. Then in addition to that, the Fed saw stresses developing that looked very similar to 2008-09.

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There were runs on money-market funds. Now, the Fed had figured in 2008-09 what to do to restore the functioning of money markets and the commercial paper market so it knew what to do. Almost every facility that was invented for 2008-09 is back in place. And that wasn't enough. So the Fed did more and it was very inventive and it's come up with new facilities.

The Fed really pulled out all the stops and I think things have improved considerably. We've got a health crisis causing an economic crisis but we don't have a financial crisis.

**HAMISH Janet, a lot of people are talking about the shape of the economic recovery. Most letters of the alphabet have been mentioned. I think we've got the Nike swoosh as another shape people are talking about. What's your view?**

**JANET** What happens definitely depends on the course of the virus and vaccines and treatments. But if I had to choose one option, I would choose the swoosh rather than a V. The thing about the swoosh is that it starts off looking like a V; you have a collapse. And I think we are seeing that. In the US, there was certainly a huge plunge, 5% negative growth in the first quarter. Most forecasters for the second quarter are looking for something in the order of negative 30% to 40% GDP growth at an annual rate. Shocking but probably May

was the bottom and we're seeing quite a few indicators suggesting an impressive recovery. There was a surprisingly positive employment report in May when there was also a strong rebound in consumer spending. There's been enormous fiscal transfers and huge monetary support. And in other countries also, we're seeing a bounce back. States in the US are now beginning to end their lockdowns. We've seen people who were on temporary unemployment spells go back to work. So it's beginning to look V-shaped. But I opt for the swoosh because I don't think that's going to continue. I think we're going to see solid growth in the second half of the year. But I'm expecting that over the course of the year as a whole, output in the US will decline by something in the 5% to 8% range. I think we'll get growth after that, but to get back to where we started will take a number of years. There are a number of reasons why. One is that there's going to be a lot of corporate failure. There'll be a need for social distancing for a long time. We're beginning to see a resurgence in the US of infection. There is all too high a probability of a second wave of infections. There've been a lot of temporary layoffs. About 75% of people who've been laid off think they're going to go back to their old jobs. They say that in surveys. But, on the other hand, 25% of people think they're not going to go back to their old jobs. My guess is that some in the 75% group will find out that they're not going to go back to their old jobs. And it's going to take a long time to get the labour market back to normal. Then there's the issue of fiscal support. There's been a huge amount of fiscal support in the US. There are individuals who aren't getting any so there are pockets of pain. But on average, unemployment compensation is very generous. The replacement ratio; namely, the percentage of pre-layoff income that people are getting, averages more than 90%. For low-income workers, it's about 100% at this point. That's extremely generous. There were US\$1,200 cheques sent out to most individuals but there's a fiscal cliff looming. A lot of the support ends this summer. Congress is talking about doing more but who knows what's going to happen. So there's a lot to retard a recovery. Thus I expect a swoosh, not a V.

**HAMISH Janet, what risks worry you the most?**

**JANET** I worry about the permanent job losses and how those people are going to get re-employed. I think it's going to be a long, drawn-out process. I find it hard to imagine that hospitality, travel, tourism and consumer-facing sectors will come back to anything close to where they were for a very long time. So there's going to be a lot of permanent layoffs in those

sectors. Structural changes that are underway in sectors such as retail will be accelerated. I'm enjoying working from home and I know a lot of firms that have no intention of going back to their old ways of doing business. Changes are going to occur as a consequence of living through this. I'm worried about many furloughed workers, their attachment to the labour market. I think there will be people who don't come back and are permanently sidelined. And I'm very worried about the degree of fiscal support, which we truly need to keep the recovery going. And I don't know if that's going to be there.

**HAMISH Janet, the virus is running rampant in many emerging markets. What happens if we get a massive capital outflow in six months time in these emerging markets? They will be under enormous stress. Will the Fed accept any collateral to keep open swap lines for US dollars?**

**JANET** I would be surprised if the Fed went further with emerging markets. Because this crisis has been caused by a virus, Congress has been very supportive of the Fed stepping in to help to keep credit flowing in a way that it was not in 2008-09. In the crisis a decade ago, a lot of people felt banks were responsible for what was happening. And they did not support Fed efforts to try to contain the damage to financial markets. This time, there's a lot of support for the Fed acting, but there are still limits.

**HAMISH Janet, many people are focused on the scale of quantitative easing and the scale of fiscal deficits. The Fed has already expanded its balance sheet by about \$3 trillion since the end of February. People say this will inevitably lead to inflation. How concerned are you about inflation and could we see higher interest rates?**

**JANET** I'm not at all concerned about inflation for let's say a time horizon of two, three or four years during which the economy is recovering. I think we're going to need very low interest rates for a long time. Inflation is under downward pressure. This is a supply and demand shock. But the decline in demand, which tends to lower inflation, is much larger than the decline in supply, which creates isolated upward pressure in some sectors. And you've already seen, at least in the US, inflation numbers that are extremely low. So I'm not

worried about inflation at all in the short term. If the economy recovers, now it gets to be a different story because we get to the point where the Fed may need to raise interest rates to stop demand from outstripping supply. And there's nothing to worry about with the Fed buying all those assets. Often people think, OK, they bought all those assets, trillions of dollars' worth of assets. It'll continue. And they created all those bank reserves. And that's money and money causes inflation. But that's not how it works because we think of money and what we're taught in our economics classes is that money is an asset that pays no interest. But bank reserves do pay interest. They pay whatever interest the Fed decides is appropriate. At the moment, the Fed has decided zero is appropriate. But when the time comes, when higher interest rates are appropriate, that stuff you call money, those reserves that now pay zero, they're going to pay interest. The Fed is going to raise the interest rate. They're going to become more like debt and not like what we think of as money and it's not going to cause inflation.

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**HAMISH** But there might be countries in the world that decide they're not going to pay any interest on their excess reserves. Is there a risk that might happen in some economies?

**JANET** I believe that's more of a political question than it is an economic question. Independent central banks with inflation mandates, when they see that higher interest rates are needed to contain inflation, they raise interest rates. That's usually the end of the inflation risk. But the political angle comes in because we're going to have an enormous federal debt. And when the Fed decides to raise interest rates, that's going to increase the interest burden on that debt. And it's going to begin to put some real pressure on the government budget. And the government will

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have to raise taxes, cut spending, do painful things as interest payments get larger. At the moment, interest payments are very, very low and they’re going to stay low as long as interest rates are low.

**HAMISH** Do you think central banks can lift interest rates to put the brakes on the economy when higher interest rates will make it harder for governments to cope with their debts?

**JANET** If central banks start raising interest rates it has an impact on fiscal policy. It has to become more contractionary. And if that happens, it means that there’s less need to raise them to very high levels. But we’re generally very worried about secular stagnation, weak spending in the economy, an environment in which there would be a prolonged reason for interest rates to stay low. And I think the pandemic has just intensified that problem. So I don’t think we’re going to go back to a world anytime soon where interest rates need to be high to contain inflation. But life is uncertain. Sometimes central banks lose their independence when the governments decide they’ve really got problems and they’ve got to go to that agency down the street and force it to hold interest rates low and buy the debt the government issues. That’s how you end up with very high or hyperinflation. I don’t think that’s going to happen in the US.

**HAMISH** Janet, if you take a longer-term view, what are you most optimistic about at the moment?

**JANET** I’m optimistic about progress on vaccines and treatments. We’ve got a very inventive scientific community that’s very hard at work. What I hear about vaccine development is very positive. And so conceivably late this year, early next year, we’ll have vaccines that are going into production. I’ve been pleased that Congress and the administration have supported a very active role for fiscal policy. I’m worried about what’s going to happen this summer, but I’m optimistic that there will be continued support. We do have an election coming up and I’m hopeful that we will come out of that with a renewed willingness to address some of these problems and a more organised strategy.

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Former Chair of the US Federal Reserve

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To watch the full video interview (~45 mins) please visit: [2020.magellaninreview.com.au](https://2020.magellaninreview.com.au)

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