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US Public Policy, Municipals, and US Economics Research

Phase Four Stimulus: CARES Act 2.0

- As COVID-19 continues to spread and the economy deteriorates, Speaker Nancy Pelosi (D-CA) has shifted discussion about a fourth stimulus package focused on recovery policies (eg, infrastructure) to one of emergency preparedness, healthcare, and strengthening the social safety net by bolstering the CARES Act, often referred to as the Phase Three stimulus package.
- Current epidemiological models forecast that the virus will peak in different regions in the US from mid-April through late May. Our Data Science team *found* that the growth rate of confirmed COVID-19 new cases is slowing in New York, reflecting the effect of social distancing policies, and has fallen nationwide as well. This is a promising sign that the epidemiological models – which account for the social distancing measures – may be accurate at projecting the peaks of the virus in different regions in the US.
- We expect real GDP growth in Q1 to fall by 1.5% q/q saar, and look for a substantial drop of -35% in Q2. Thereafter, we expect activity to recover sharply, but we forecast Q4/Q4 growth to be down 4.7%, as much of the lost services sector activity will likely not be made up. We expect the unemployment rate to peak at 13.6% and decline to 8.5% in Q4. In 2021, we forecast above-trend growth and look for the unemployment rate to fall to 5.0% by year-end.
- Although negotiations continue, we think there is bipartisan support for a Phase Four stimulus package, it may surpass $1trn and pass in the coming two months. We expect this package will focus on emergency healthcare support, financial assistance for individuals and businesses, expanded social safety provisions, and support for state and local governments. Phase Four may be affected by a possible smaller package ($200-500bn) focused on financial assistance for small businesses (sometimes referred to as Phase 3.5) that may pass Congress in the coming weeks.
- States and local municipalities received $150bn in the Phase Three package; however, these governments may need more assistance, given resource constraints. We estimate that their tax revenues will drop by about $350bn, expenses will increase, and assets of defined benefits pension plans took a $750-800bn mark-to-market hit.
- Aside from the additional monetary aid to municipalities, tax-exempt advance refundings as well as Build America Bonds (BABs), might possibly be resurrected, which will provide issuers with much-needed flexibility in accessing the primary market, although we have not heard any public statements made on this subject recently.

Public Policy Research
Shawn Golhar
+1 212 526 0172
shawn.golhar@barclays.com
BCI, US

Municipal Research
Mikhail Foux
+1 212 526 7849
mikhail.foux@barclays.com
BCI, US

Economics Research
Michael Gapen
+1 212 526 8536
michael.gapen@barclays.com
BCI, US

COVID-19's Impact on Framing a Phase Four Package

As the cases and fatalities continue to mount in the US, Speaker Nancy Pelosi (D-CA) has shifted discussion about a stimulus package focused on recovery policies – such as infrastructure – to one of emergency preparedness, healthcare, and strengthening the social safety net by bolstering the previous stimulus measures. As we wrote in our *Global Outlook*, the CARES Act – the Phase Three stimulus package signed on 27 March 2020 and expected to cost at least $2.3trn – will not be enough for households, businesses, and state and municipal governments (Figure 1). A Phase Four stimulus package – structured as a second installment of the CARES Act – may be the start of several measures from Congress that could stretch well after the November elections. We continue to expect legislation focused on the national recovery, which may include infrastructure funding; however, it will likely not come until after the US is past the emergency phase of the crisis.

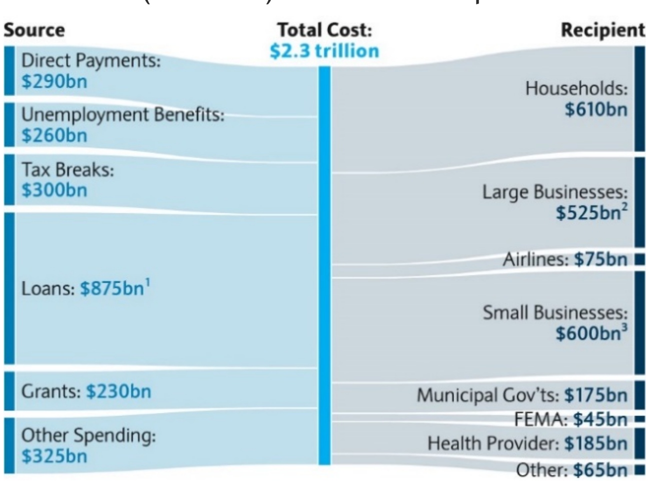
Rolling COVID-19 Peaks Expected across the US

Future Congressional action will depend on the spread of COVID-19 and the impact on healthcare and the economy. Current epidemiological models forecast that COVID-19 will peak in different regions in the US from mid-April through late May (Figure 2). Although the president outlined federal guidelines for social distancing and lockdowns, it has been up to the governors to interpret and enforce these policies. Given the exponential growth rate, the lack of a national lockdown may lead to rolling peaks across the US over the next two months with renewed concerns about subsequent outbreaks.

Political voting preferences may have played a role in enforcing lockdowns. A recent study at the University of Washington found that on any given day during the epidemic, Republican governors have been 42% less likely than Democratic ones to mandate social-distancing measures (defined as bans on large gatherings, school closures, business/restaurant restrictions, and stay-at-home orders). When they implemented these policies, they have done so, on average, two days later. For states that President Trump won at least 58% of the vote in by 2016, these measures were delayed by an additional day. When adjusted for population density to take into account the urban/rural – and corresponding Democratic/Republican divide – researchers still found a "clear association" between the results of the 2016 presidential election and the response to the virus.[1]

FIGURE 1

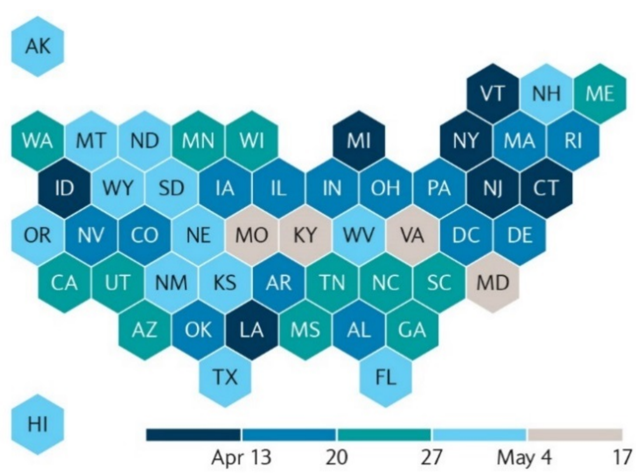
Phase Three (CARES Act) – sources and recipients



Note: (1) up to $366bn forgiven; (2) includes $454bn to set up a $4.5trn Fed facility; and (3) includes $170bn of tax cuts for businesses other than corporations. Source: Committee for a Responsible Federal Budget, Barclays Research

FIGURE 2

Hospital demand is projected to peak in April to May



Source: Institute for Health Metrics and Evaluation, Axios, Barclays Research

[1] Source: "Pandemic Politics: Timing State-Level Social Distancing Responses to COVID-19," multiple authors at the University of Washington, 28 March 2020; "American states' responses to the coronavirus follow party lines," *The Economist*, 2 April 2020.

Lastly, according to our colleagues in our Data Science team, the effect of social distancing should appear in the data for states that were early to implement these measures.[2] For instance, in New York it found that the growth rate of confirmed COVID-19 new cases is currently slowing, reflecting the effect of social distancing policies, and that it has fallen nationwide as well. This is a promising sign that the epidemiological models may be accurate at projecting the peaks of the virus in different regions in the US.

US Economic Outlook: Stay-at-home orders lead to cliff-effects on activity

While the Congressional Budget Office (CBO) continues to update its model, as of now, its analyses assume that social distancing measures will decrease by three-quarters, but not entirely, by the second half of 2020. With that caveat, their preliminary estimates for Q2, as 2 April 2020, show a 7% decline GDP and unemployment rate over 10%. Longer term, it currently projects unemployment by the end of 2021 of about 9%.

In our revised 2020-21 US outlook (see *Stay-at-home orders lead to cliff-effects on economic activity*, 2 April 2020), we detail why we believe the US economy is already in recession based on incoming data that point to cliff-effects in activity. In particular, the unprecedented rise in initial jobless claims suggests the unemployment rate in April will rise well above the peak reached in the global financial crisis. We expect real GDP growth in Q1 to fall by 1.5% q/q saar, and look for a substantial drop of -35% in Q2 (Figures 3 and 4).[3] Thereafter, we expect activity to recover sharply, although we forecast Q4/Q4 growth to be down 4.7% because much of the lost services sector activity will likely not be made up. We expect the unemployment rate to peak at 13.6% and decline to 8.5% in Q4. In 2021, we forecast above-trend growth as we expect the economy to be supported by fiscal and monetary policy, and look for the unemployment rate to fall to 5.0% by year-end. In our revised inflation outlook, we assume declines in energy prices, a stronger trade-weighted value of the dollar, and persistently high unemployment will outweigh the effects of any supply chain disruptions. As a result, our forecast for core CPI falls to 1.3% y/y in early 2021 before finishing the year at only 1.6%.

FIGURE 3

Revised GDP growth scenarios…

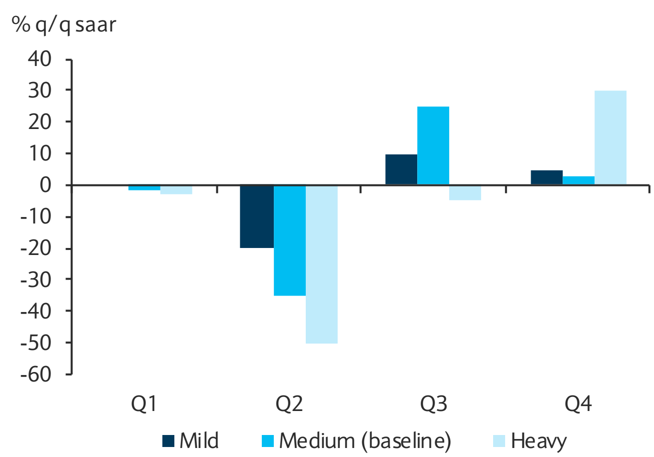
US 2020 real GDP growth: Scenarios

%q/q saar	Pre-COVID-19	Mild	Medium (baseline)	Heavy
Q1	1.5	0.0	-1.5	-3.0
Q2	2.0	-20.0	-35.0	-50.0
Q3	2.5	10.0	25.0	-5.0
Q4	2.0	5.0	3.0	30.0
Q4/Q4	2.0	**-2.0**	**-4.7**	**-12.0**
% y/y	2.0	**-1.9**	**-4.5**	**-11.1**

Source: Barclays Research

FIGURE 4

…include much deeper declines in Q2 and y/y



Source: Barclays Research

[2] Refer to Barclays Research – *US COVID-19 case growth is finally slowing, but economic damage is not*, 6 April 2020.
[3] Given the elevated uncertainty, we think providing one modal baseline path is less informative and we have altered our normal presentation of the US outlook to include alternative scenarios. Our "mild" outbreak scenario includes assumes the US and global economy suppresses the outbreak more quickly and returns to normal functioning in May, versus June in our medium (baseline) outbreak scenario. Our "heavy" outbreak scenario also includes second-round effects from credit frictions, distressed events, and additional layoffs.

Our outlook for the US economy is somewhat more favourable than that of the CBO for two reasons. We are somewhat more optimistic about the ability of states to remove state-wide stay-at-home orders in the coming months and we are also pencilling in additional Phase Four fiscal spending on the order of $500bn each for this year and next (eg, over and above our estimates for Phases One through Three). The CBO is constrained to forecast under a "constant policies" assumption; we are under no such restriction. Additional fiscal spending supports our outlook for above-trend growth in 2021 and a more rapid decline in unemployment relative to CBO baseline assumptions.

Possible Components of the Phase Four Stimulus

Expressing a sense of emergency, Speaker Pelosi quickly pivoted her focus from recovery policies to the need for a fourth bipartisan bill that expands on the CARES Act.[4] While negotiations continue, the total cost of a Phase Four stimulus package may surpass $1trn and we think there is a high likelihood it passes in the coming two months. In addition, given the economic challenges for small business, Congress is currently negotiating a smaller package (Phase 3.5) focused on small businesses. With the goal of passing a Phase 3.5 in the coming weeks, Speaker Pelosi and Congressional Democrats may aim to include the following provisions in a Phase Four plan:

- **Healthcare and emergency preparedness:** Funding for PPE (personal protective equipment) for healthcare and other frontline workers. Securing enough PPE and other healthcare supplies has been a significant challenge across the US. In fact, the Department of Health and Human Services (HHS) recently issued a report (Refer to "Hospital Experiences Responding to the COVID-19 Pandemic: Results of a National Pulse Survey March 23–27, 2020," Office of Inspector General, US Department of Health and Human Services, Apr 2020) that detailed "severe shortages" of supplies, insufficient testing kits, uncertainty about availability from the federal government, increased supplier prices, challenges maintaining adequate staffing, inconsistent guidance from the federal, state, and local authorities, amongst other issues. Failing to secure enough PPE may lead to additional fatalities.

- **Assistance for state and local governments:** Funding for municipalities to replace lost/depressed revenues and cover higher expenses. While Congress continues to negotiate, our research in this report shows that tax revenues will drop by about $350bn, expenses will increase, and assets of defined benefits pension plans may experience a $750-800bn mark-to-market hit.

- **Rebate checks for individuals:** An additional one to three months of direct financial assistance. For qualified Americans, the previous checks were $1,200 per individual, $2,400 for married filing jointly, and $500 per child. The Joint Committee on Taxation *estimated* that the current cost of the rebate program was $292bn. According to the US Treasury, the majority of the Phase Three payments will be made in April. The IRS plans to prioritize payments according to financial need so those that qualify at the higher end of the income spectrum will receive payments as late as September. As a point of comparison, there was a lag of at least 12 weeks for direct payments to individuals under the Economic Stimulus Act of 2008 under President George W Bush.

- **Unemployment insurance:** Expand funding to assist those who have lost their jobs.

- **Paid sick leave:** Eliminate some employer exemptions from the CARES Act (e.g., exempts companies with 500+ employees) and expand benefits.

[4] "Pelosi Pares Goals for Next Stimulus…," *Bloomberg*, 3 April 2020.

- **Nutritional/food support:** Expand SNAP (Supplemental Nutrition Assistance Program) funding.
- **Small-business financial assistance:** Provide additional funding for small businesses. While this is on their list, at the time of this publication, a portion ($200-250bn) of Phase 3.5 may provide supplemental funding to expand the Paycheck Protection Program (PPP), which was originally funded with $349bn.
- **Sector-specific assistance:** Several industries are advocating for additional financial assistance.
- **Tax law changes:** Some Democrats have called for an increase to the SALT deduction as well as making the change retroactive to allow taxpayers to re-file previous 2018 and 2019 returns. Not surprisingly, Republicans immediately rejected the idea and we do not expect this to be included in Phase Four, at this time.

In terms of timing, given the record number of unemployment claims, a collapsing labor market, and a healthcare sector at capacity, Speaker Pelosi aims to have a Phase Four bill ready for negotiation later in April. Although Congress is not currently scheduled to back in session at the Capitol until 20 April, Majority Leader Steny Hoyer (D-MD), the number two in the House Democratic leadership, recently informed his colleagues to maintain "very flexible" schedules as they may have to return to Washington before the April 20. Senate Republicans expressed a more cautious approach as many want to see the effect of Phase Three and the mitigation measures.

Additional Help for Municipalities is Needed

The CARES Act provided substantial help to states and municipalities (in addition to individuals and businesses, which in the end will also help local economies), including the $150bn direct aid program to states and local municipalities, $30bn for an Education Stabilization Fund, $25bn to transit providers and $100bn for hospital providers. Although it is definitely a good start in our view, many local policymakers have been arguing that much more is needed to address the economic damage caused by the COVID-19 pandemic. Consequently, a significant portion of the Phase Four stimulus may be dedicated to provide additional help to states and local municipalities.

Tax Revenue Losses Are Staggering

The majority of states were in a relatively good shape prior to the COVID-19 crisis, with their "rainy day fund" balances at the all-time record (Figure 5). There are some outliers, but overall states and local municipalities have been benefited from strong economic growth, robust housing and equity prices, and the Tax Reform of 2017, which created additional revenue for high tax states. Up until this pandemic, the main sources of revenue for municipalities – property tax, individual income tax, and sales tax – constituted the bulk of revenues alongside corporate income tax (Figure 6).

To provide historical context to the potential deterioration in state revenues, we look to the global financial crisis. In 2007, total revenue for the US states amounted to $1.995trn. By 2009, total revenue at the state level fell to $1.133trn, for a decline of 43.2%. The combination of lower revenues and balanced budget amendments was a factor in reducing employment at the state and local level by about 800,000 over a four-year period. Employment at the state and local level did not begin rising until five years after the end of the recession. We believe policymakers would prefer to avoid repeating this scenario following the COVID-19 outbreak, where state budgets and the state employment situation are impaired for several years or more.

If we assume that municipal revenues follow the ups and downs of the US GDP, we can project their movement over time (Figure 7). Using this approach, we expect states and local municipalities lose about $350bn in revenue: about $110bn in FY20, and close to $240bn in FY21. In reality, we might actually see an even larger revenue drop, and the Federal government may not be inclined to absorb all the lost revenue because it would be expected to rebound as the economy recovered.

Thus far we have discussed just the revenue part of the equation; expenses will also have to increase significantly, as they will have to be supporting hospitals, schools etc. In essence, the ultimate effect on the finances is actually much larger than $350bn.

Moreover, by moving the deadline for filing taxes to 15 July, states/municipalities were also negatively affected, as states get a substantial portion of their tax payments close to the deadline, which in 2020 partially will end up being paid in the next fiscal year. In the past week, the State of New Jersey moved the end of its fiscal year to 30 September. In general, states should have authority to do this, and it is probably the right thing to do for most of them in the current environment, because delaying the end of the tax year will give states a much clearer picture of their finances, in our view. Meanwhile, emergency spending appropriations will need to be approved to bridge the gap.

Pension assets are taking a big hit

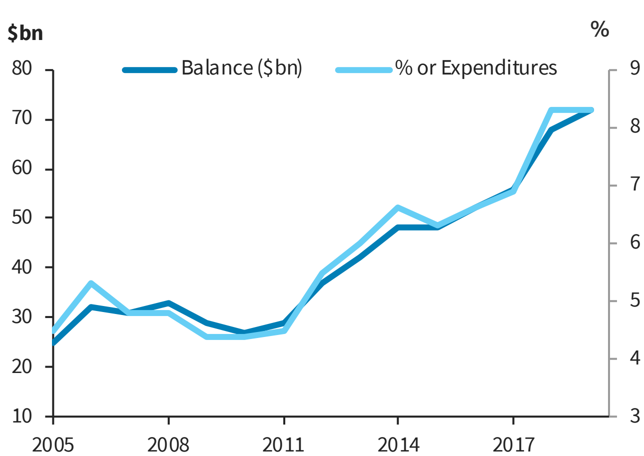
In addition to the immediate effect from lower tax receipts, there is a medium-term challenge to states – underfunded pension liabilities for defined benefit pension plans. Underfunded pension liabilities have been always at the forefront of municipal investors' minds, as these underfundings were already more than $4trn at the end of 2019, bringing funding levels to just 55%, with some outliers such as Illinois, New Jersey, and Kentucky faring much worse than the rest.

Most of these pension plans used relatively aggressive asset return assumptions (7-7.5%), although as a result of a massive bull market in equities in the past several years, most pension funds were actually able to reach their targets. Moreover, given such aggressive return assumptions, most pension funds were forced to put the bulk of their assets into equities and other investments with higher risk profiles (Figure 8).

It worked well during the bull market, but this sudden bear market that started in March has put a major dent in the pension funds' funding levels. Although valuations might recover somewhat by the end of the year, based on the year-to-date performance of the

FIGURE 5

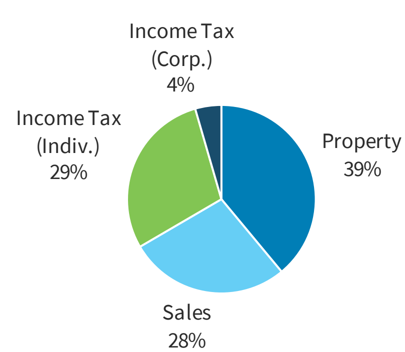
States' Rainy Day Funds at Record Highs



Source: NASBO

FIGURE 6

Tax Revenue Breakdown by Type (2019)



Source: US Census

major equity and fixed income indexes, we estimate that mark-to-market losses for most defined benefit pension funds this year are on the order of $750-800bn.

In addition to the tax revenue losses discussed in the previous section, it is clear to us that after the COVID-19 crisis is over, many states will find themselves in a much more difficult position with respect to their pension liabilities, which will likely force them to make hard decisions.

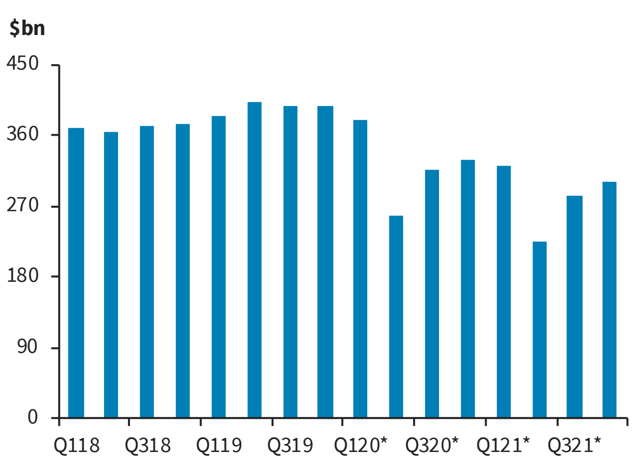
Expanding the Federal Reserve Act to Permit Purchases of Municipals

In one of the most important provisions of the CARES Act, the Treasury contributed up to $454bn to Federal Reserve lending facilities that would have the ability to purchase the bonds of, or extend loans to, corporates and municipalities. These lending facilities would be conducted under section 13(3) of the Federal Reserve Act and need approval from the Treasury. Treasury also needs to contribute a capital buffer to indemnify the Fed against potential losses. The Fed can leverage this capital contribution and, based on ratios observed during the global financial crisis, could possible extend credit up to $4trn if the entire $454bn in funding were applied and demand for the facility was high. Section 13(3) emergency lending authority is needed for the Fed to extend credit to corporates and municipalities since the Fed does not have express authority to purchase corporate bonds or municipal debt outright as part of its open-market authority. At present the Fed can only purchase Treasury securities, government-backed agency securities, and municipal debt with remaining maturity of six months or less. Decisions to purchase US Treasury or agency mortgage-backed securities as part of the Fed's open-market authority can be undertaken with approval from the FOMC and does not require approval from Treasury or the invoking of "unusual and exigent circumstances" under section 13(3).

However, some Democrats want to expand the Fed's authority to buy munis even further. Senator Bob Menendez (D-NJ) proposed to amend the Federal Reserve Act in order to allow the Fed purchase municipal bonds at times of stress as part of its open-market capabilities and authorize the Fed to have another congressionally mandated goal that designates it to be the buyer of last resort of the debt of troubled states and municipalities. This would greatly expand the Fed's authority in the area of municipal securities and would put municipals on equal footing with regard to Treasuries and mortgages in future rounds of large-scale asset purchases. That said, as we noted in *Municipal Strategy: What Munis the Fed Will Likely Buy* (30 Mar 2020), the Fed may be reluctant to use its potential expanded authority when it comes to purchasing municipals. Historically, the Fed has preferred to stay

FIGURE 7

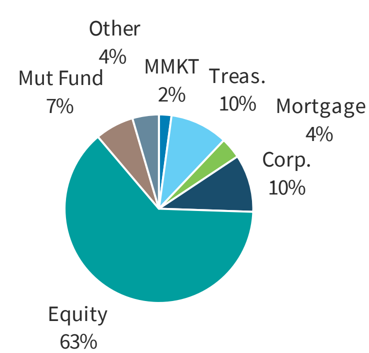
Tax Revenues for States and Local Governments (seasonally adjusted)



Source: US Census

FIGURE 8

Defined Benefit Pension Plans (by type)



Source: Fed Flow of Funds

out of decisions regarding troubled financial states because this is viewed as more properly under the purview of the Treasury. In addition, decisions to purchase the debt of some states and not others could leave the Fed open to potential political criticism. Finally, the municipal market has many layers and issuers that could complicate the design of any purchase strategy. In our view, the Fed would prefer to support municipals, if needed, through section 13(3) since it does so as an agent of the Treasury and not as a principal through direct purchases.

Bringing Back Primary Tools

As one of the main goals of the Phase Four is expected to be to provide additional help to municipalities, we believe that some market tools might be resurrected to ease access to the primary market. For example, we might see tax-exempt advance refundings that were sunset in the aftermath of the 2017 tax reform, as well as Build America Bonds (BABs), albeit with a lower federal subsidy, potentially brought back. Both programs would not cost that much money to the federal government, but could provide much needed flexibility to issuers. If not on a permanent basis, these two programs may be brought back for a period of 12-24 months.

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