Fed Watch

AIB Treasury Economic Research Unit

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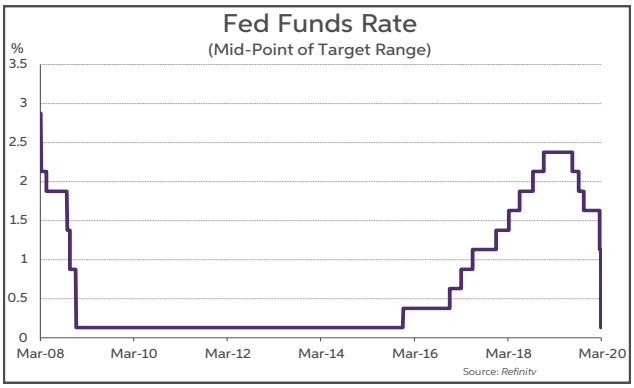
Fed cuts rates to zero; restarts QE; new swap measures

On Sunday, the Federal Reserve met, bringing forward its scheduled March 17th/18th FOMC meeting. In an effort to mitigate the economic fallout from the coronavirus, the central bank voted to cut the key funds rate by 100bps. This followed a 50bps cut earlier in the month and leaves the target range for the funds rate at its post 2008 financial crisis lows of 0.00-0.25%. Forward guidance was strengthened, with the meeting statement outlining that rates will remain at their current level until the FOMC is "confident that the economy has weathered recent events and is on track to achieve its maximum employment and price stability goals". A further reduction in the funds rate appears unlikely, with Chair Powell commenting that "we do not see negative policy rates as likely to be an appropriate policy response here".

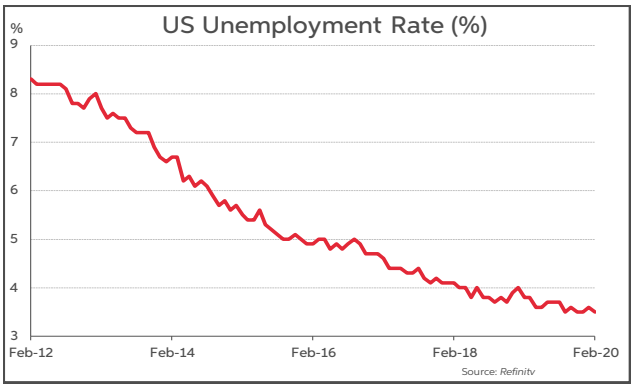


The Fed also formally announced that it will restart its QE programme, with $700bn of purchases to be made "over the coming months". The central bank intends to buy $500bn of Treasuries across the curve, as well as an additional $200bn of mortgage-backed securities. All principal payments will be reinvested.

Additional measures taken by the FOMC include a 150bps cut to the "discount rate", the rate at which the Fed charges banks to borrow from it. The term length of these loans has also been extended to 90 days. The reserve requirement has been slashed to 0% and banks have been encouraged to use their capital and liquidity buffers to lend to the real economy. In a separate measure, reflecting concerns over the availability of dollar funding, the Fed stated that fresh USD liquidity swap lines have been put in place with a number of other central banks.

The meeting decision was not unanimous. One member of the FOMC opposed the decision to cut rates by 100bps, instead voting in favour of a 50bps reduction. However, the additional action taken by the central bank had unanimous support.

In the post meeting press conference, Fed Chair Powell acknowledged that while US data were solid prior to the outbreak, the coronavirus is having a "profound" impact on the economy, with the energy, hospitality and travel sectors hit hardest. He also stressed that the outlook remains highly uncertain, stating that how widely the virus spreads is in effect "unknowable". On this basis, the Fed opted against releasing updated macro forecasts, with Powell commenting that they "could have been more of an obstacle to clear communications than a help".



Overall, the additional measures taken by the Fed with regard to liquidity are aimed at staving off a possible credit crunch that could be brought about by reduced cash flows due to lockdowns, as well as expected ratings downgrades. With two-thirds of non-financial corporate debt in the US ranked "junk" or "BBB" (one category above junk), there is a risk of a severe dislocation in credit markets with the economy facing a major downturn. This in turn could create the conditions for a financial crisis, a situation that 2008 has showed us is far more difficult to recover from than a conventional recession. The Fed is hoping that yesterday's moves will prevent this from occurring. It is also now crucial that the government picks up the mantle and provides fiscal support to offset the shock to private demand.

With regard to the market impact, the Fed's moves have not becalmed markets. Asian and European equities have sold off heavily since the meeting, though this also reflects the impact of the economic dislocation associated with the continued spread of the coronavirus. On fixed income markets, US Treasuries have outperformed, suggesting that the central banks measures have been well received. 10-year yields have fallen by approximately 20bps. FX-wise, the reaction in the dollar has been somewhat more muted, though the currency has adopted a marginally softer tone in this morning's trading session.

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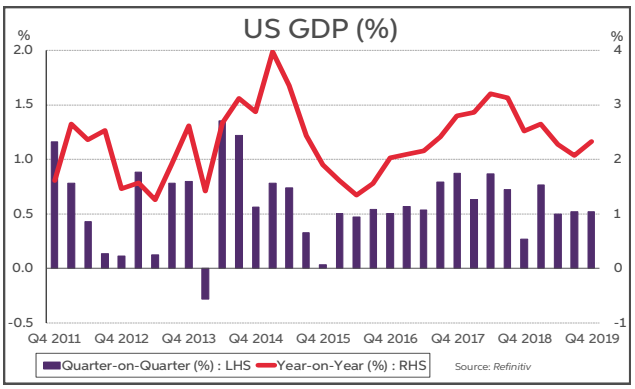
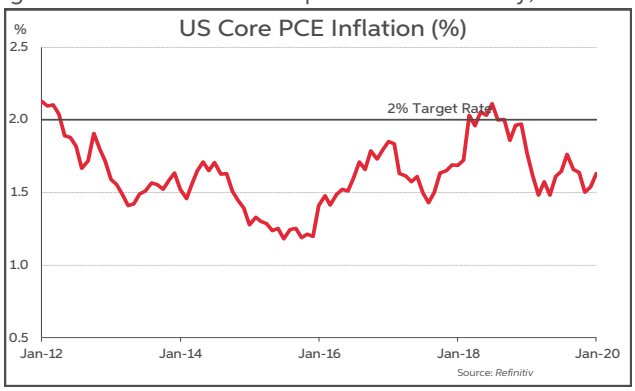
US economic growth strong prior to virus

The US economy expanded by a solid 2.1% in annualised terms in the final quarter of last year, matching Q3's rate. This left the annual average growth rate for 2019 at 2.3%, down from 2.9% in 2018. Consumer spending moderated in Q4 but remained a key driver of activity, contributing 1.2 percentage points (p.p.) to the Q4 total. Government spending added a further 0.5p.p.. Meanwhile, the unwinding of stockpiling in previous quarters boosted net trade (+1.5 p.p.), though this was partly offset by a fall in inventories (-1.0 p.p.).



With regard to survey data for Q1 2020, the first impact of the coronavirus was seen in the February PMIs. The composite index fell below the key 50 threshold for the first time since 2013, with both the manufacturing and service sector sub-indices in contractionary territory. The manufacturing ISM also lost ground in February falling from 50.9 in January to 50.1, possibly reflecting early disruptions to supply chains. In contrast, the non-manufacturing index rose from 55.5 to 57.3. Looking ahead, sharp falls are expected in the March surveys. Indeed, initial indications of this were seen in the decline in the flash estimate of the University of Michigan measure of consumer sentiment for March.

The hard data available for January were somewhat mixed. Retail sales were up by a decent 0.3%, but this followed a weak Q4. The improvement was even less marked in the 'control' sub-index (proxy for consumer spending), which was unchanged in the month. Meanwhile, industrial production declined by 0.3%, with the Boeing partial shutdown acting as a headwind to output growth. Better data are expected for February, but the outlook for the coming months is grim.



Prior to the arrival of the coronavirus in the US, the labour market was performing strongly. Aided by mild weather, non-farm payrolls increased by 273k in both January and February, up from an average monthly gain of 178k in 2019. This has helped the unemployment rate fall to a multi-decade low of 3.5%.

Despite the tightness of labour market conditions, earnings growth remains subdued. Wage inflation has been confined to a 3.0-3.5% range since the summer of 2018, with no discernible trend in place. As a result, price pressures have remained relatively muted. The Fed's preferred measure of inflation, core-PCE, stood at just 1.6% in January. In contrast, core-CPI edged up to 2.4% in February, though it will likely moderate over the next few months. Meantime, lower energy prices saw the headline measure of CPI ease to 2.3% from 2.5%.

To surmise, the outlook for the US economy is highly contingent on the rapidity of the spread of the coronavirus and the efforts to contain it. In the near term, a sharp decline in GDP is a certainty. Disruptions to supply chains, financial market volatility and the general impact on demand prompted by the outbreak, will all create significant issues for firms in the coming months. Issues with cash flows means that there is a risk of a credit crunch, which could create the conditions necessary for a financial crisis. The energy, hospitality and travel sectors are particularly vulnerable, with the US shale sector likely to suffer severely given the collapse in oil prices. More generally, firms will scale back their hiring plans, and may begin to let go workers. Softness in the labour market, combined with the recent sharp decline in consumer sentiment, will provide an unsupportive backdrop for consumption, which accounts for circa 68% of US economic activity. More pertinently, lockdowns will prevent households from spending.

The substantial easing measures carried out by the Fed in the past few weeks will help to mitigate some of the economic fallout from the virus outbreak. Monetary policy easing acts with a lag, but the rate cuts will help to support investor sentiment. Efforts to inject liquidity may help prevent a dislocation in credit markets. Meanwhile, sizeable fiscal stimulus appears likely, though concrete details in this regard would be beneficial. Such measures will be necessary to provide crucial support for the economy.