Central Banks

FOMC Statement: March 3rd

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In an unscheduled and abbreviated statement, the Fed announced an emergency 50bp cut to 1-1.25% in the Fed Funds rate, similar to the response to 9/11. The S&P 500 has dropped 11.3% since February 19th, as the number of COVID-19 cases outside of China grew, moving market sentiment from one consistent with moderate financial tightening to one consistent with a pandemic-like correction. While U.S. economic fundamentals remain strong, as evidenced by resilient household balance sheets, improving investment outlook, strong labor markets and stable inflation, the move to head off the "evolving" risks that coronavirus presents should improve market sentiment.

Outside the dire effects that increased mortality rates will have on labor supply, workers with cold or flu-like symptoms will be more likely to stay home, telecommute or change their normal working schedules, implying a drag on productivity and hours worked. However, according to our estimates, assuming an R-naught of around 2.5 and a CFR of 2-3%, the supply-side shock should be low.

That being said, nonessential travel has been greatly reduced or eliminated at a nontrivial share of U.S. corporations, major events have been postponed or cancelled and, domestic and international tourism is bound to slow down over the spring travel season. As such, the demand-side impact could be significant on both growth and prices. According to our estimates, assuming protracted dislocations, the demand-side shock to U.S. GDP growth in 2020 could be around 0.4%. However, these estimates are subject to ambiguity given the elevated uncertainty related to the magnitude and duration of the disruption.

Although the reduction in the Fed funds rate could help normalize the yield curve somewhat unwinding some of the narrowing of the slope and reduce the "belly" inversion, the monetary policy toolkit is not well equipped for dealing with supply-side shocks and non-business cycle related uncertainty. In fact, despite today's Fed action, the S&P 500 closed 2.4% lower while the 10-year Treasury yield declined to 1.01%, setting a new record low.

Nonetheless, more accommodative monetary policy should increase the attractiveness of residential homebuyers in need of a mortgage, refinancing activity and boost purchases of consumer durables such as autos. The risks to highly leveraged firms facing higher spreads, tighter credit conditions and uncertain profit outlooks should also ease, although the appetite for corporate debt remains muted.

Without a doubt, global institutions are preparing for a worst-case scenario given that the likelihood of a near term resolution is fading. Earlier today, the G7 Finance Ministers and Central Bank Governors, released a statement indicating that they are "…closely monitoring the spread of the coronavirus disease 2019 (COVID-19) and its impact on markets and economic conditions." Finance Ministers stand ready to take actions, including fiscal measures while central banks will support price stability and economic growth.

Bottom Line

We believe the Fed will cut rates an additional 25-50bp in March/April. In fact, today's statement indicated that: "The Committee is closely monitoring developments and their implications for the economic outlook and will use its tools and act as appropriate to support the economy." Fed futures markets are also discounting between one and two 25bp rate cuts before the end of the summer.

In addition, we anticipate the Fed will be overly cautious with its balance sheet policy, possibly to the point of increasing its asset holdings modestly beyond what would be consistent with the growth in nonreserve liabilities. Ultimately, a shift to a risk management strategy à la 2019 implies that the Fed will be very cautious about counteracting the increased accommodation in interest rates with additional changes to its monetary policy framework.