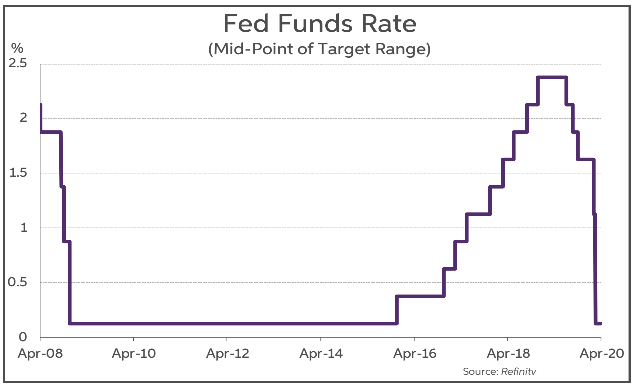
Fed Watch

AIB Treasury Economic Research Unit

30th April 2020

Fed leaves already very loose policies unchanged

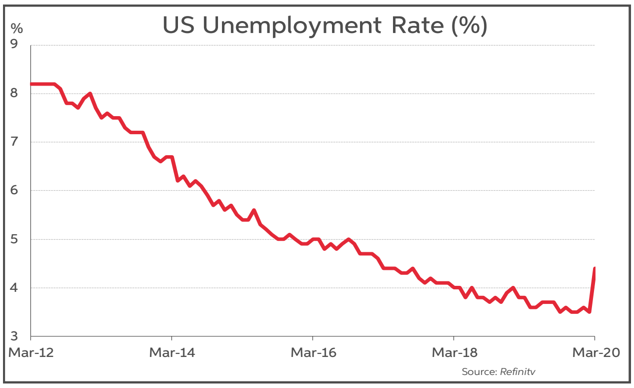
The Federal Reserve Open Market Committee (FOMC) meeting concluded last night with no changes to policy. The decision to leave policy unaltered was unanimous. This was very much in line with expectations as since March, the Fed has already introduced an extensive package of monetary stimulus measures in an effort to mitigate the economic fallout from the Covid-19 crisis.



This has included cutting the fed funds rate by a total of 150bps to a target range of 0.00-0.25%. The Fed also restarted its QE programme, initially by $700bn and then subsequently expanding it to unlimited purchases.

Additionally, the Fed has undertaken measures to support the flow of credit to the economy. It views this as an essential ingredient in alleviating the headwinds facing the economy, as well as setting the stage for the subsequent recovery. These measures have been aimed at all sectors of the economy: households, small and medium size firms, large corporates, state and local governments. They have included specific credit and liquidity facilities, as well as lending programmes, which equate to over $2trn. On top of all this, the reserve requirement ratio was cut to zero and banks were encouraged to use their capital and liquidity buffers to lend to the real economy. The FOMC has also re-implemented fresh US dollar liquidity swap lines with a raft of other central banks to ease pressures on dollar funding.

In the post meeting press conference, Fed Chair Powell comments highlighted the exceptional economic shock hitting the US economy arising from the Covid-19 pandemic. He stated that it is clear that the effects on the economy are severe, noting that million of workers have already lost their jobs. Chair Powell also commented that consumer spending, which is typically the engine of US growth, has “plummeted” as people are forced to stay at home as part of the Covid-19 containment restrictions. Against this backdrop, he said that the Fed expects economic activity will likely drop at an “unprecedented rate in the second quarter”.



The meeting statement and Powell’s remarks in the press conference emphasised that the Fed is willing to do whatever its takes, within its policy remit, to help the economy deal with the severe shock to activity. The central bank re-affirmed that it expects to maintain the current level of its key interest rate until it is confident that the economy has weathered recent events and is on course to achieve its dual mandate of maximum employment and price stability. In a response to a question about any further action, Chair Powell answered that the Fed has a “number of dimensions” on which it can still provide support to the economy and that its credit policies are not subject to a specific dollar limit.

However, he pointed out that for many individuals or businesses, getting a loan that could be difficult to repay may not be the solution. Instead, direct fiscal support may be the more appropriate and effective action. Chair Powell noted that this type of direct support will be very important in limiting any long lasting damage to the US economy following the crisis.

There was little market reaction to the outcome of the FOMC meeting. In terms of market expectations, futures contracts would appear to be looking for a 12.5bps Fed rate hike to 0.25% at the end of 2022. Further out, these contracts suggest the market is anticipating the fed rate getting to 0.50% by September 2024. Meantime, we will have to wait for the Fed’s next meeting in June for the central bank’s own forecast regarding the impact of the Covid-19 pandemic on the US economy.

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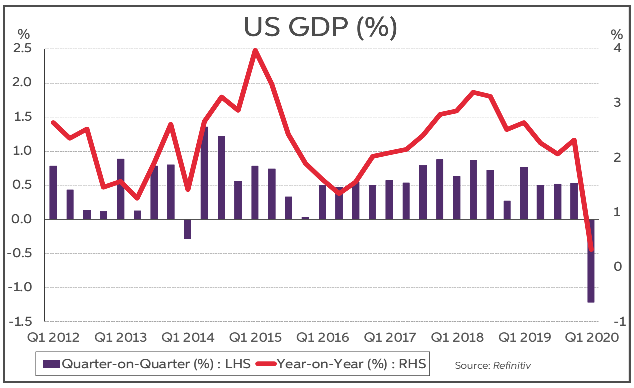
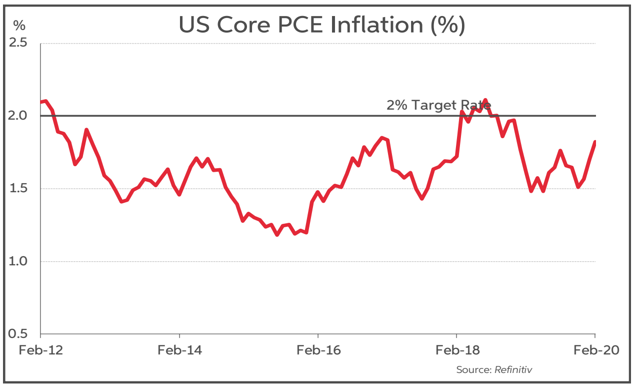
US economy contracts sharply on Covid-19 impact

US GDP fell by 4.8% in annualised terms in the opening quarter of the year, bringing an end to the economy's longest expansion on record. The contraction reflects the instant impact the Covid-19 restrictions, which were put in place in March, have had on activity. In Q1, consumption plummeted by 7.8% on an annualised basis as retail outlets closed and unemployment spiked. Business investment fell by 2.6%, contracting for a fourth consecutive quarter. Exports declined by 8.7%, but net trade made a positive contribution to growth as imports plunged by 15.3%. Meantime, government spending rose by a modest 0.7%.



With regard to the labour market, non-farm payrolls dropped by 701k in March, rivalling declines seen in the aftermath of the financial crisis in 2008/09. This saw the unemployment rate increase to an over 2 year high of 4.4%. However, the March employment report reflected only the initial impact of the Covid-19 lockdown. Jobless claims have spiked by some 26m in the past 5 weeks. The government has moved to provide loans to firms to keep employees on payroll, but the claims figures still point to a very big jump in the unemployment rate, which could now be above 15%. Next week's US employment report for April is expected to show non-farm payrolls plummet by an unprecedented 20 million. More generally, wage inflation will likely moderate in the coming month given the growing slack in labour markets.

Easing earnings growth and reduced demand should also see core inflation fall in the coming months. The March print of core-PCE, the Fed's preferred inflation index, is not yet available but the ex-food and energy measure of CPI fell back to 2.1% in March from 2.4% as airfare and hotel room rates plunged. At the same time, plummeting oil prices saw headline CPI decelerate from 2.3% to 1.5% in the same month.



The limited amount of data available for Q2 suggests that the US economy is on track for its worst recorded quarterly performance. The flash Markit PMIs lost further ground in April, with the data more fully capturing the widespread imposition of lockdowns. The composite index dropped to 27.4 from 40.5, driven by a collapse in the services PMI to 27 from 39.8. The decline in the manufacturing index has been less severe and it stood at 36.9 (output index at 29.4). However, it has been boosted by lagged supplier delivery times, which reflect disrupted supply chains. On the demand side, the Michigan measure of consumer sentiment posted its largest ever monthly fall in April, though it remains well above its post-financial crisis lows.

The outlook for the US economy is highly contingent on how long the measures to contain Covid-19 remain in place. However, a drastic drop in GDP is a certainty in Q2, as current lockdown restrictions will be only gradually unwound. The lockdown will hammer discretionary consumer spending in the quarter, while providing an extremely unhelpful backdrop for investment, which is already reeling from the collapse in oil prices. Significant government stimulus programmes will, though, provide some support to activity. **The substantial action carried out by the Fed in the past few weeks will also help to mitigate some of the economic fallout from the virus outbreak and has gone some way in preventing the emergence of a financial crisis.** Stock markets have rallied strongly in recent weeks, having fallen by one-third between mid-February and mid-March.

The latest IMF forecasts, which assume a 12-week lockdown and a gradual easing of restrictions thereafter, are for the US economy to contract by 5.9% in 2020. This would be the economy's worst performance since 1946, when it shrank by 12%. However, the downside risks to the IMF's forecast are substantial. Containment measures may need to remain in place for a longer time period than assumed. States have begun to re-open in recent days, but lockdowns may need to be reintroduced if the virus takes hold in these areas again. More generally, the possibility of a second, smaller wave to the virus later this year cannot be discounted. The IMF is forecasting that the US economy can grow by 4.7% next year on the assumption that Covid-19 has abated.