Fed’s emergency rate cut failed to calm markets

After a terrible week in equity markets at the end of February, investors were looking for decisive action from central banks and priced in significant near-term easing, particularly by the Fed. Markets rallied on reports that G7 finance ministers and central bank governors were discussing a coordinated response, but sold off when the meeting failed to deliver any explicit policy commitments. Just hours later, the Fed acted unilaterally by announcing an emergency 50 basis point rate cut, two weeks ahead of its next scheduled meeting.

If the move was meant to calm financial markets, it failed—the S&P 500 ended up losing nearly 3% on the day. Why wasn’t a large, surprise rate cut enough to buoy sentiment? While the Fed’s forward guidance that it will “use its tools and act as appropriate to support the economy” suggests the door is open to further easing, Chair Powell’s comment that the Fed likes its current policy stance wasn’t exactly the commitment to action investors were hoping for. Powell also didn’t provide details on any other measures the central bank might take to ensure sufficient liquidity in the financial system or the availability of credit to borrowers facing a cash crunch.

More easing likely, but lower rates aren’t the only solution

Even after the Fed’s 50 basis point cut, markets are pricing significant easing from the Fed over the coming months. There’s no shortage of uncertainty around the scale and duration of the economic impact of the coronavirus outbreak, or the central bank’s response. At this stage, we’re penciling in another 25 basis point rate cut by the Fed in the near-term, and acknowledge that there’s risk of even more easing. How much heavy lifting the Fed has to do will depend on the response from other policymakers—as Chair Powell said, monetary policy is only part of what needs to be a multi-faceted approach by policymakers. While lower rates might bolster sentiment in financial markets (even if that wasn’t the case with the Fed’s surprise rate cut) and help shore up business and consumer confidence, fiscal stimulus can be better tailored to address the effects of an outbreak.

The Trump administration hasn’t exactly been forthcoming in that regard, though the president did sign off on an $8.3 billion emergency spending bill. It’s objective, though, is more to address the early stages of the outbreak (pledging more than $3 billion for R&D of vaccines, treatments and testing and more than $1 billion for international efforts to help contain the virus’ spread) rather than the coming economic fallout. As the economic impact of COVID-19 becomes clearer, we think more significant, targeted measures to support affected households and businesses could be on the way.

Waiting on the economic impact of COVID-19

The US economy is entering this period of uncertainty with decent momentum. GDP growth averaged 2.1% (annualized) over the second half of last year. And improving business and consumer sentiment and solid payroll growth in January and February suggests activity remained solid prior to the coronavirus outbreak in the US. Even with economic disruption likely to increase in March, we think Q1 growth will come in close to trend at 1.7%. The economic hit is likely to be concentrated in Q2 when efforts to contain the outbreak are likely disrupt economic activity, adding to supply chain and confidence shocks. Our early estimate is for growth to be cut in half to 0.8% in the upcoming quarter, though at this stage we can’t rule out a flat or even negative print for Q2 GDP.

Our forecast assumes economic activity will begin to recover over the second half of the year, both as the outbreak fades and policy support takes effect. We think GDP growth could rebound to a 2% pace in the second half of the year. That likely won’t be enough for the Fed to immediately reverse rate cuts (November’s election also complicates things) so we expect fed funds will remain in a 0.75-1.00% range through the end of the year. As the recovery takes hold, we expect Treasury yields will trend modestly higher over the second half of 2020 but aren’t likely to reach last year’s close of around 1.9%.