

Mounting concerns that the coronavirus could spread further have sent markets into a tailspin. Major equity indices in the US and Europe lost between 3.1% and 4.6% on Thursday, with the S&P 500 Index and the Nasdaq Composite Index recording their largest respective declines in more than eight years<sup>1</sup>. In this note, our macroeconomic strategy team, led by Chief Economist Frances Donald, explains why the outbreak could nudge the US Federal Reserve (Fed) into lowering interest rates sooner than expected. Indeed, the team thinks that a March rate cut isn't entirely unthinkable.

## Coronavirus update: A material economic reassessment

In summary, we see:

- Mounting deflationary pressures in many parts of the world
- Rising probabilities of a US interest-rate cut before June as the global economic shock deepens
- Weak first-quarter US data will likely provide the Fed a reason—or cover—to act quickly and trim rates soon, well before the US election

### A US interest-rate cut in the cards?

Over the past two months, we've emphasised that the impact of the coronavirus outbreak would be more pronounced and more global than markets had anticipated. We also noted that while a US recession isn't in the cards, the first quarter would be a pain point for US growth, with economic data likely to disappoint. Crucially, until recently, the markets had severely underpriced the odds of a rate cut.

An escalation in the outbreak has increased our conviction on these three themes, but it's also led to violent price movements this week. The market is now pricing in a full 25 basis points rate cut from the Fed by June,<sup>2</sup> which has been our view for the past six months. Critically, we believe the Fed could act

at its next meeting on 18 March, and that the likelihood of more than one rate cut by June is quickly rising.

What will a Fed rate cut accomplish? For a start, a rate cut is necessary to prevent a disorderly rise in the US dollar (USD), an abrupt mover higher in US Treasury yields—events that could lead to a sizable tightening of financial conditions. Naturally, a rate cut could also potentially soften the decline in equities.

Clearly, the challenge facing the US economy isn't about access to capital or the cost of capital. However, the downside risks to growth—combined with disinflationary pressures and the need for the Fed to act quickly and decisively while rates are close to the “zero lower bound”—imply rate cuts are fast becoming a necessity. Indeed, what we've experienced in the past six weeks could very easily qualify as a “material reassessment” of the economic outlook for the Fed.

Here's why.

### 1. Global economic data is weak and will continue to be weak

We've written extensively about the coronavirus outbreak over the past two months. In summary, we believe that:

- The coronavirus outbreak is a true “black swan” event—one which the markets cannot properly assess or price just yet.
- While data remains limited, high-frequency indicators available so far suggest China may

<sup>1</sup> Bloomberg, as of 28 February, 2020.

<sup>2</sup> Bloomberg, as of 26 February, 2020.

have actually contracted in the first quarter. Supply chain ramifications will be sizable and global in nature, particularly for Europe, which remains to be the bellwether of the supply chain for developed markets.

- The US economy may be more insulated than most, but it isn't immune to supply or demand shocks.
- The risk of financial contagion as a result of rising defaults/failure to pay creditors among small and medium firms caught in the disruption remains low, but if it does occur, the damage will be considerable.
- We remain concerned about a bleed-through to developed-market consumer behavior, particularly in Europe, Australia, and Canada. The United States is also vulnerable to confidence shocks—Tuesday's [comments](#) from the US Centers for Disease Control and Prevention, however well intentioned, will likely inspire fear.

From a growth perspective, we believe a “consumer confidence and spending” shock would represent the most problematic aspect of the escalation in the coronavirus outbreak. It's also worth noting that unlike supply-side shocks, demand-side shocks aren't always recouped (i.e., if you didn't buy a latte one day, you don't necessarily buy two the next).

And yet, what particularly irks us is that the global economy is facing this shock *not* from a place of strength but from a place of weakness—following a fairly pronounced global manufacturing recession. Instead of a recovery, we're now likely to see a double-dip of economic weakness. In other words, **we believe it's time to throw out the “V-shaped” recovery narrative and start thinking more about a “W-shaped” track.**

Meanwhile, economic data suggests Japan and Germany (the third- and fourth-biggest economies in the world, respectively) were already underperforming *before* the coronavirus outbreak. While not our base case, we believe both Germany and Japan are at serious risk of slipping into recession in the first half of 2020.

## 2. The deflationary impulse cometh

Apart from the disinflationary pressures of a global economic slowdown, the inflation picture for 2020

looks worse now than it did at the start of the year. Within the context of a US central bank that's attempting to create an inflationary *overshoot* and a more “symmetric” inflation target, the following developments support further monetary easing:

- The trade-weighted USD has risen since the start of January, which has a mechanically deflationary impact on inflation.<sup>2</sup>
- Most importantly, market-based inflation expectations have plummeted. This is a critical component to the Fed's inflation outlook. As Fed Vice Chair Richard Clarida noted in a [speech](#) on Friday, “inflation expectations reside at the low end of the range” that he considers to be “consistent with our price stability goal.”<sup>3</sup>
- The commodities complex—with the exception of gold—is clearly in correction mode.<sup>2</sup> This will feed through to both headline and core prices in time to come (the latter with a lag). Shipping data also suggests oil imports by China, Japan, and South Korea—the countries most affected by the outbreak—are down one-third in the past three months relative to the prior three months.<sup>2</sup>
- We expect China and EM Asia to export particularly large deflationary pressures through producer price declines and a weakening of their domestic currencies.
- Finally, even if we were to strip out the impact of the outbreak, base effects suggest US consumer price index had peaked in early-to-mid February.

## 3. The yield curve is inverting ... again

Arguably, an inverted yield curve is a funding problem, but it's also an issue that could have important implications for growth if the Fed doesn't cut rates soon. We could be looking at a disorderly rally in the USD, a tightening of financial conditions, and a further equity sell-off (as a result of the first two factors)—none of which is constructive to growth. Does that mean that the bond market can bully the Fed into cutting? From

<sup>3</sup> “Financial Markets and Monetary Policy: Is There a Hall of Mirrors Problem?” Federal Reserve Board, 21 February, 2020.

a market perspective—yup, pretty much.

## 4. A strong US dollar is problematic

The US economy has more or less decoupled from the rest of the world and there's no doubt it's likely to be the most resilient to the coronavirus; it's a relatively closed economy and domestic demand has remained strong. However, that decoupling has also created a conundrum for the Fed as it strengthens the USD: A stronger greenback weighs on US manufacturing activity, tightens global financial conditions, and, as mentioned, is deflationary.

While it's in most central banks' interest to dismiss suggestions that they could be trying to influence exchange rates, we believe a great deal of central bank activity in the coming years will be fueled by adjusting rates to stimulate foreign exchange channels. In our view, that's probably the only major mechanism through which monetary policy is still effective at stimulating growth.

## 5. Weakness in upcoming US data could create opportunity to lower rates

As mentioned, we continue to believe that the first quarter of 2020 will be a pain point for US growth. In fact, we've already identified some budding issues that could lead to economic disappointment in the coming months:

- Services Purchasing Managers' Index—which is closely followed by the Fed—slipped into “contraction” territory in February. Two things to note: First, total new orders fell for the first time in over a decade, and second, the contraction isn't all caused by the coronavirus outbreak. According to the survey, respondents were concerned about a likely economic slowdown and uncertainty ahead of November's US presidential election.<sup>4</sup>
- Boeing 737 MAX production shutdowns, which are likely to resume around June, are widely expected to weigh on growth.
- Monthly retail sales data, particularly the

“control group” used in the final GDP calculation—which excludes food services, autos, building materials, and gas stations—has been sluggish in the past five months.<sup>2</sup>

- In our view, there's also a reasonable chance that the US jobs market could cool slightly in March/April.

Under normal circumstances, these data points would certainly **not** be sufficient to nudge the Fed into cutting rates, particularly when the US housing sector is displaying signs of health. But at this point, we're inclined to believe that these pockets of weakness will provide the Fed with the cover it needs to potentially introduce “insurance cuts.”

Finally, the upcoming election could also influence the timing of the Fed's rate cut. While the Fed will *never* admit that it's at all swayed by the election, the desire to steer clear of any suggestions—even the perception—of political meddling will, at the margin, encourage the central bank to cut sooner rather than later. After all, this is also consistent with the Fed's own research that emphasises cutting fast and early as an economy approaches the zero lower bound.

## Market view: buying the dip?

Broadly speaking, from a longer-term perspective, we still believe that the coronavirus outbreak could lead to buying opportunities. However, the events of the past two weeks have led us to think that the “dip” may be deeper and longer than most have initially expected, and we may still be some distance away from putting risk back on the table. In other words, the market has yet to find a bottom. However, further monetary easing from global central banks and the introduction growth-friendly fiscal measures as a result of the outbreak could support a rebound in the second half of the year and we still believe equities will end the calendar year higher than where they are today.

<sup>4</sup> IHS Markit, 21 February, 2020.

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