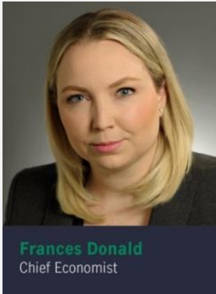

The Fed has lowered interest rates by 50 basis points (bps)[1] in its first intermeeting cut since 2008[2]. While an interest-rate cut was widely expected, market reaction suggests investors might have been underwhelmed. Our Global Chief Economist and Head of Macroeconomic Strategy Frances Donald shares her views.

Emergency interest-rate cuts are here

The US Federal Reserve's (Fed's) announcement arrived roughly two hours after G7 finance ministers and central banks released a joint statement pledging to take additional action to support the economy and price stability. We now expect every major central bank, including the Bank of Canada and the European Central Bank, to ease rates either at or before their next respective rate-setting meetings. In addition, we believe the Fed will follow up with an additional 25 basis points (bps) interest-rate cut when it next meets on 18 March.

What does the Fed's 50bps rate cut accomplish in the midst of a health crisis? It's true that the rate cut won't rectify the disruption to the global supply chain, boost consumer spending, or help to contain the spread of the coronavirus (COVID-19). However, in theory, it should help unwind the tightening of financial conditions and act as a cushion for the recent decline in risk assets. Crucially, the rate cut could put a lid on US dollar strength, which can evolve into a headwind for US growth, lower the cost of corporate credits, and support refinancing activity for US households.

Why, then, did risk assets move lower? In our view, there could be two reasons for this:

1) The Fed's rate cut doesn't appear to be coordinated with other major central banks.
2) The US central bank could be perceived to be panicking (somewhat) about growth.

From where we stand, we could certainly see a variety of issues that might lead to a further fall in asset prices in the coming one to two months that could weigh on risk, absent a sudden improvement in COVID-19 cases.

The market has priced in additional rate cuts: more disappointments ahead?

As of this writing, the bond market is pricing in *more* than one rate cut at the March meeting,[2] and at least one additional rate cut after that. No prizes for guessing that we believe it'll be incredibly difficult for the Fed to meet those expectations. In essence, the markets are expecting the Fed to keep lowering interest rates, signal that there'll be further rate cuts, and confirm that it has no intention of unwinding those cuts, even if the economic conditions were to improve. It's fair to say that this is an extremely difficult ask; the path ahead for the Fed will likely be tricky, with plenty of scope for policy errors and miscommunication.

The global economy will likely slow dramatically in Q1, Q2 and possibly Q3

In our view, interest-rate reductions simply aren't the appropriate prescription for healing supply chain shocks, plain and simple. It's almost certain that China's economic shutdown in the past two months—and possibly beyond—will continue to weigh on global trade, manufacturing, and business investment. This is particularly problematic given that the global economy isn't confronting the anticipated slowdown from a place of strength, having been weakened by heightened trade

[1] "Federal Reserve issues FOMC Statement," federalreserve.gov, 3 March 2020.
[2] Bloomberg, 3 March 2020.

tensions in the preceding 18 months. While we expect an improvement by the fourth quarter of this year, we believe global growth will continue to deteriorate for several months—with or without globally coordinated rate cuts. And that means lower corporate earnings, globally.

The United States isn't insulated from external shocks

We're seeing preliminary evidence of demand shocks permeating through the United States, although they remain less severe than supply chain-related issues at this point. In the coming weeks, we believe several economic indicators relating to the services sector (including retail spending) could miss expectations, and we continue to be concerned about the jobs market.

While it's true that the US consumer remains very strong fundamentally, thanks to high employment, rising wages, a high savings rate, and a relatively low debt burden, a confidence shock could keep an otherwise "healthy" consumer from spending—and that's exactly what COVID-19 is likely to do.

Separately, we also believe it's important to look out for signs of weakness in the credit markets. The double whammy of a supply-side shock and a demand-side shock is likely to hurt corporate revenues, which can lead to a spike in missed debt payments. While China can direct banks to roll over loans and extend payment deadlines to ease the pressure on Chinese companies, the rest of the world isn't able to respond in a similar fashion (at least, not without resorting to extraordinary measures). Interest-rate cuts can help to ease the pressure on debt obligations, but they won't remove the risk entirely.

There's still a US presidential election coming up

While recent headlines have mostly been focused on the coronavirus breakout and the expected Fed rate cuts, financial markets will also be contending with news flow relating to the US 2020 presidential election. In our view, the election will continue to play a part in driving market behavior. Any development suggesting that we could see a change in the Oval Office come November is unlikely to be well received by the markets.

Fiscal stimulus could be on its way

While it's true that caution is warranted in the short term, we remain committed to our view that the medium-term outlook will be a lot brighter. We might take a little longer than expected to get there, and much of it will depend on how quickly the coronavirus outbreak is contained but get there we will—with a little help from various fronts.

In our view, it seems clear to everyone, including central banks, that monetary policy isn't the most appropriate tool to deal with the current crisis. Fiscal spending is clearly the more effective tool, since it enables policymakers to directly target weaker geographic regions or business sectors and to help to alleviate confidence shocks.

We've seen some developments on this front—Italy has led the charge so far [3], and we believe policymakers in the United States and United Kingdom could follow. The joint G7 statement from the finance ministers on Tuesday stated that they "are ready to take actions, including fiscal measures where appropriate, to aid in the response to the virus and support the economy during this phase."[43] We view that as a positive—with lower rates, it's also fairly cheap for policymakers to finance these initiatives.

Is fiscal policy therefore a near-term upside risk? From a market sentiment perspective, yes. But when it comes to fiscal policies, the lead time between announcement and actual implementation is typically pretty long. It could be a few *years* before we'll experience the positive impact of these policies, although measures such as payroll tax cuts or cash transfers can have an immediate effect on consumer spending and growth. That said, not all fiscal packages will be effective. Ultimately, their effectiveness will depend on how well thought out they are and how they're implemented.

[3] "Statement of G7 Finance Ministers and Central Bank Governors," U.S. Department of the Treasury, 3 March 2020.
[4] "Italy unveils €3.6bn stimulus to tackle coronavirus," Financial Times, 1 March 2020.

Lower rates, which act like a tax cut, can boost refinancing activity

We don't expect rate cuts to suddenly encourage major consumer spending or power the already strong-performing housing market further. However, lower rates can spur refinancing activity, which can have a similar effect to placing extra cash into the pockets of those who choose to refinance. In other words, it can act like a tax cut. While concerns about the outbreak might deter consumers from spending that cash at this point, things will change as the virus dissipates. Crucially, that pent-up demand will do much to help accelerate the eventual recovery.

Inventory restocking and the absence of inflation could support growth

At the beginning of the year, we noted that inventory levels globally were lower than they should be and that the global economy should derive some support as restocking takes place. While firms aren't likely to hop on the restocking bandwagon until virus fears have dissipated, it will happen eventually.

Finally, while the absence of inflation can be problematic, it can also spell relief for businesses. For one, it could mean that rate hikes are nowhere on the horizon, which suggests firms aren't likely to face a destructive rise in input costs or wages. In our view, these factors could be supportive of global growth in important ways that are bullish for risk assets.

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