Fed Watch

AIB Treasury Economic Research Unit

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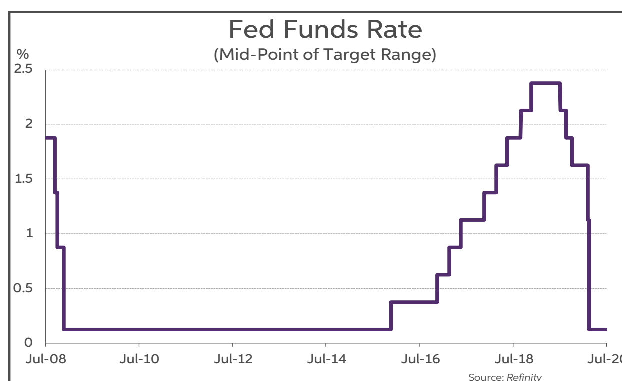
Fed downbeat on outlook but leaves policy unchanged

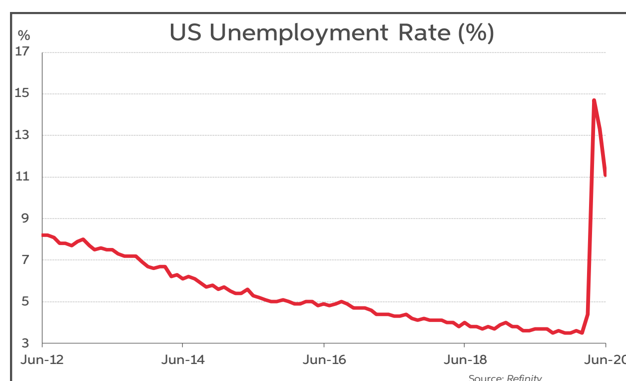
The July meeting of the Federal Open Market Committee (FOMC) concluded as expected yesterday evening with no changes made to policy. The decision to leave policy unaltered was unanimous. Since March, the Fed has introduced an extensive package of monetary stimulus measures and liquidity supports in order to mitigate the economic fallout from the Covid-19 crisis and to stabilise financial markets.



These measures included a 150bps cut to the fed funds rate, leaving it at a target range of 0.00-0.25%. The Fed also restarted its QE programme, initially by $700bn and then subsequently expanded it to unlimited purchases. At present, the central bank is buying $80bn of Treasuries and $40bn of Mortgage-Backed-Securities a month. Additionally, the Fed launched a plethora of lending and credit facilities, which were recently extended until the end of the year. Dollar swap lines were also re-introduced with a number of foreign central banks and it was yesterday announced that these will remain in place until March 31st 2021 in order to prevent fresh strains re-emerging in dollar funding markets.

Meanwhile, the meeting statement was broadly unchanged from June. The Fed acknowledged the recent signs of improvement in the labour market, but noted employment remains "well below their levels at the beginning of the year". The central bank added that "the path of the economy will depend significantly on the course of the virus" and will maintain its ultra loose monetary policy stance "until it is confident that the economy has weathered recent events and is on track to achieve its maximum employment and price stability goals".

In his press conference, Chair Powell continued to emphasise that the outlook for the US economy is extraordinarily uncertain. He commented that "a full recovery is unlikely until people are confident that it is safe to re-engage in a broad range of activities" and acknowledged that the recent re-imposition of measures to contain the spread of the virus are now starting to weigh on economic activity. The Fed will use its tools to support the economy through the crisis but, as Powell acknowledged, the FOMC has "lending powers, not spending powers". In other words, further fiscal stimulus, which according to Powell has "made a critical difference" is also required.



The latest macro forecasts from the Fed are from June, though they are somewhat outdated given the recent resurgence in new Covid cases. It projected a decline in GDP of 6.5% year-on-year in Q4'20, followed by growth of 5% y/y in Q4'21 and 3.5% in Q4'22. It expects that the unemployment rate will end this year at 9.3%, falling to 6.5% by end-2021 and at 5.5% by end-2022. The Fed sees inflation remaining below its 2% target over the next 3 years.

Against this backdrop, the Fed does not envisage hiking interest rates until at least 2023 at the earliest. The June interest rate projections showed that all 17 FOMC members believe the current level of rates will be needed until at least the end of 2021. Meanwhile, 15 of the 17, expect no rate increases in 2022. **Markets, though, are discounting that the next move in US rates could be downwards, with a small cut priced in taking the midpoint of the range for the funds rate down closer to zero.**

Overall, the tone emanating from the Fed's July meeting was one of caution. The central bank sounded more dovish than in June, reflecting the resurgence in new Covid cases in large parts of the country. As a result of the mounting challenges facing the economy, further easing appears likely this year. This is most likely to involve a further ramp up in the pace of monthly asset purchases, though the small rate cut priced in by markets cannot be ruled out. Due to the lack of policy changes, there was no major reaction from the dollar or in bond markets to the meeting outcome.

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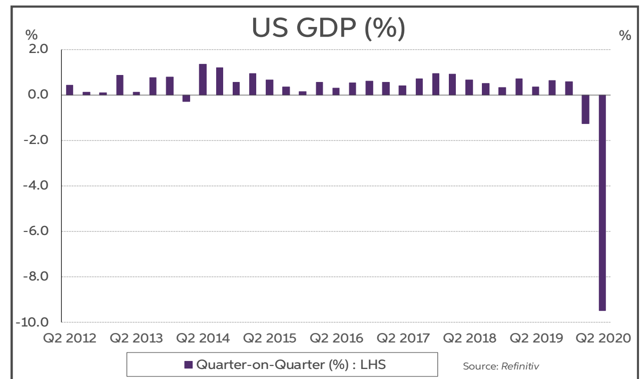
Covid-19 prompts historic US GDP contraction

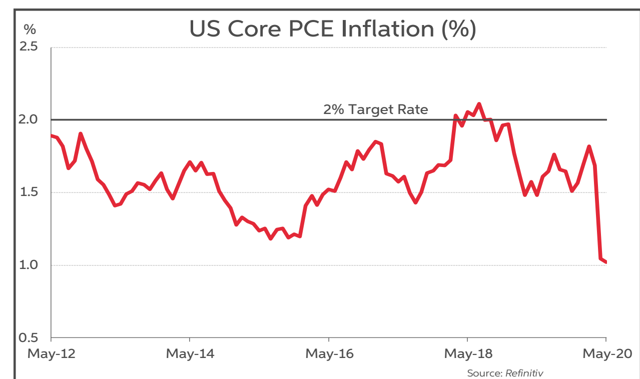
US GDP collapsed by an unprecedented 32.9% in annualised terms in Q2 following a 5% drop in the opening quarter of the year. This left the year-on-year rate at –9.5%. The severity of the contraction reflects the impact of the Covid-19 lockdown. The most severe restrictions were in place throughout April and have only been gradually lifted. A resurgence in new infections saw states pause their re-opening schedules toward the end of the quarter.



In terms of the breakdown, consumption plunged by 34.6% on an annualised basis as shopping outlets closed and labour market conditions deteriorated. At the same time, business investment sank by 29.9%. The only domestic demand component to post a rise was government spending, though it increased by just 2.7%. With regard to the external sector, net exports were a positive contributor, though they added just 0.7 percentage points to GDP.

Turning toward Q3, the limited survey data available for July suggests that the economy has returned to expansion mode as Covid-19 restrictions have been gradually removed. However, the aforementioned 'second wave' in the South and West of the country is weighing on the recovery. The composite PMI rose back to the key 50 threshold in the month. The services index, though, was registered at just 49.6, up from 47.9 in June. The sector has been disproportionately impacted by the pandemic. Meanwhile, the manufacturing PMI climbed up to 51.3 from 49.8. On the demand side, both the University of Michigan and the Conference Board measures of consumer confidence lost some ground in July.

In terms of the labour market, non-farm payrolls increased by 4.8m in June (May: +2.5m) as the re-opening of the economy prompted firms to begin to rehire workers. However, payrolls still remain some 14m below their February peak and there has been a worrying rise in permanent job losses. The situation in the South and the West is also clouding the outlook for jobs growth and layoffs remain elevated. Meanwhile, the unemployment rate was put at 11% in June. However, officials warned that classification issues probably underestimate the actual rise in unemployment.



Weak demand, due to the impact from the Covid crisis, saw the Fed's preferred measure of inflation, core-PCE, hold at a joint 9-year low of 1% in May. The core CPI rate also remained at 1.2% in May, its lowest since March 2011. Meanwhile, a partial rebound in oil prices saw the headline measure pick up to 0.6% from 0.1%.

Looking ahead, the short term outlook for the US economy, as is the case for many other advanced economies, is very challenging. After the historic contraction in Q2, a bounce back is likely in the third quarter. However, in the absence of a vaccine or a significant advancement in treatment measures, the economy will be required to operate below capacity in order to contain the resurgence in new virus cases. Firms will find it difficult to operate in this environment and bankruptcies are likely to continue to rise. This will pose a significant headwind to both consumer spending and investment. It is also quite concerning that enhanced jobless benefits, a key support for household expenditure, are set to expire at the end of the July. Any subsequent extension of the programme is likely to be considerably less generous. **More positively, the substantial easing measures being implemented by the Fed will at least support activity.**

The economic projections published by the OECD recently show a 7.3% contraction being forecast for the US economy in 2020. This would represent the economy's worst performance since 1946 when it shrank by 12%. However, the downside risks are substantial. The virus has proven more persistent than anticipated and in order to curtail its spread more stringent restrictions may need to remain in place over the winter months in particular. There is also the possibility that a vaccine takes longer than anticipated to obtain. **Overall, the OECD is forecasting that the economy will grow by 4.3% next year if these downside risks can be avoided.**

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