NAB CHANGE IN FED FUNDS RATE CALL 4 MARCH 2020

FED TO FURTHER CUT RATES AT ITS MARCH AND APRIL MEETINGS

NAB Economics

We expect the Fed to cut rates by 25bps at each of its March and April meetings. The risks are skewed to it taking even more aggressive easing measures.

- The Fed cut rates by 50bps overnight. While it indicated that it considers the fundamentals of the economy are still strong, it cited the risks from the coronavirus in its decision.
- The Fed's statement did not provide any guidance about what it's next steps might be. However, we expect the Fed to cut rates at its March meeting (17-18 March) and again in April (28-29th). We are tentatively pencilling in 25bps at each of these meetings, which would take the fed funds target range to 0.5 to 0.75%. For now, we are assuming that the Fed will keep the fed funds rate at this level through our projection period (to 2021) but the risks around this are skewed towards it being more aggressive in the near term (but with a risk of partial reversal of the rate cuts further out assuming growth recovers in the second half of this year).
- As reports of the virus spreading through the US (and globally) accumulate, the experience in other countries is that consumers will pull back, particularly in travel and other recreational events (although there may be some hoarding of essentials as an offset). Press reports are indicating that conferences are being cancelled, business travel is being cut back, and some businesses are moving to having staff work from home (which will impact service activity around normal business locations). Supply disruptions may also start to become more apparent given the very limited signs of a lift in China production, and the spread of the virus to other important regions in global supply chains (Korea, Europe).
- We will release an updated set of forecasts next week, but our starting point will be a notable weakening in growth in Q1 and Q2 relative to our previous forecasts. We will be assuming that the worst of the impact will be in March and April (with gradual recovery thereafter), but clearly there is a high degree of uncertainty around the time at which the economic impacts from the virus will start to recede (and how quickly any recovery occurs). The longer, and more severely, the virus impacts the economy the greater the risk that it leads to business closures, lay-offs and a pull-back in investment which would exacerbate and lengthen any downturn.
- These uncertainties – and the risk of a far more severe impact – will also be a motivating factor for the Fed to continue to act even if it believes the most-likely scenario is only short-term disruption. This is particularly so given that inflation pressures are muted and raising the prospect of the Fed easing policy some-time this year even before the coronavirus emerged.
- Fed research in recent years has emphasised the desirability, given that policy capacity is limited, of acting quickly and aggressively when there is an economic shock. This suggests the risk to our call of two further 25bp cuts is that the Fed will act more aggressively, and markets are pricing in the chance of a 50bp cut at the March meeting. Other policy measures may also be considered, particularly if stress emerges in capital markets. How fiscal policy reacts may also influence the Fed's decisions.

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