Fed May Cut Rates Further to Counter Coronavirus Headwinds
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by Eric Winograd of AllianceBernstein

This week’s Fed rate cut helped steady financial markets reeling from the expected impact of the coronavirus on the US economy, and we think more cuts are coming—in March and beyond. The economy should rebound in the second half of the year, though at a lower full-year pace.

Wednesday’s 50–basis point rate cut by the US Federal Reserve was a mild surprise—not the size of the cut but its timing. The market and the consensus of economists—including AB’s—were geared up for a March rate cut, but uncertain whether it would be rolled out at the upcoming March 18 Federal Open Market Committee (FOMC) meeting or before then.

The Fed decided to be preemptive, in keeping with its more proactive recent stance. In 2019, it eased to provide insurance against trade-war risks undermining the economy—and that choice worked. Growth remained stable and inflation in check, even with more accommodation. So, it makes sense that the FOMC is returning to that playbook in 2020. While the rising human toll is all too clear, official data don’t yet show the weight of the coronavirus shock on the economy. However, it doesn’t take much imagination to see it coming.

More Rate Cuts Likely…During March and After

In fact, we think more rate cuts are all but certain. The FOMC almost always cuts rates again after cutting them between meetings. It’s unlikely we’ll see enough improvement in the next two weeks to jolt the Fed out of crisis mode. And if markets are banking on more support, signaling that this week’s cuts were one-and-done would undermine the Fed’s efforts.

That’s why we expect another cut at the March 18 meeting, with the size based on the amount of economic and financial disruption in the next two weeks. Our initial thought is for another 50 basis points in cuts: Academic literature is clear that a central bank without much room to maneuver must be aggressive to maximize the firepower it has left. An ounce of prevention will (hopefully) be worth a pound of cure. So, when you don’t have a pound of cure, bet on the ounce.

We also see more cuts coming after March. We don’t expect additional data that can help clarify the magnitude of the economic hit until April, so for now, we’re forecasting another 75 basis points of easing from this point (including the expected March 18 cuts). This path would slash the official short-term policy rate to a range of 0.25% to 0.50%.

Growth Should Rebound in Second Half of 2020

Where does this leave the US economy? Given the lack of visibility right now into the overall impact of the coronavirus shock and subsequent recovery, it’s speculative to forecast beyond a horizon of a couple of months. We do think the economy is likely to bounce back: this shock is intense but is also expected to be reasonably short-lived, measured in weeks or months rather than quarters.

That means the US economy will probably look better in the second half of the year than it will in the first. But we don’t think it will be better enough for the Fed to unwind the rate cuts this year. The inflation cost of last year’s cuts was trivial, and we expect a similar experience this year. With the Fed already worried that inflation is too low, there shouldn’t be enough motivation for it to hike in 2020.

For as long as the shock remains intense—and if the Fed follows the rate path we expect—already record-low US Treasury yields will likely fall further, as negative headlines proliferate and the Fed cuts. There may be some scope for yields to bounce back by year-end, but it’s hard to have conviction on that view until we get a better sense of the shape of the economic rebound.

Growth Trajectory Likely to Miss a Few Months of Output
As for the effect on 2020 US economic growth, we’re reducing our full-year forecast for gross domestic product growth from 1.7% to 1.4%. There’s a lot of variability around the forecast, and it depends a lot more on the second half of the year than on the first, so the forecast risks are skewed to the downside.

Ultimately, we think the economy will resume its previous growth trajectory but will simply be missing a few months as a result of the coronavirus impact on activity. Of course, we’ll need to reassess expectations as more data emerge that give us greater visibility.

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