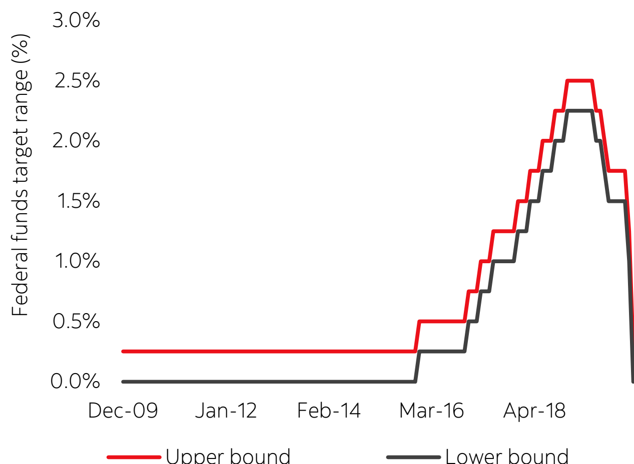
Market update: U.S. Fed cuts interest rates to near zero

Last night, before the open of Asian markets, the U.S. Federal Open Market Committee (FOMC) reduced the target range for the federal funds rate to 0%-0.25% and announced a minimum US$700 billion asset purchase program (“QE4”), consisting of at least US$500 billion of U.S. Treasury securities and at least US$200 billion of mortgage-backed securities. The Fed is also ceasing the run-off of these securities from its existing portfolio. The changes come in the wake of measures by governments around the world to slow the spread of coronavirus, which has brought the global economy to a standstill. The FOMC, recognizing that “the coronavirus will weigh on economic activity in the near term and pose risks to the economic outlook”, took the action it did in an effort to fulfill its dual mandate of maximum employment and price stability (2% inflation). The Committee added that any future adjustments to monetary policy will also be made in this context.

Yesterday’s federal funds rate reduction was unprecedented in at least one respect. Specifically, it marked the first time the FOMC has cut its benchmark rate twice between regularly scheduled meetings. The decision likely reflects the swiftness with which the coronavirus pandemic is threatening to morph into a financial crisis. Recall that on March 3rd, the FOMC cut its policy rate by 50 bps. With yesterday’s policy decision, the Committee has reduced the fed funds rate by 150 bps this month alone (Figure 1).

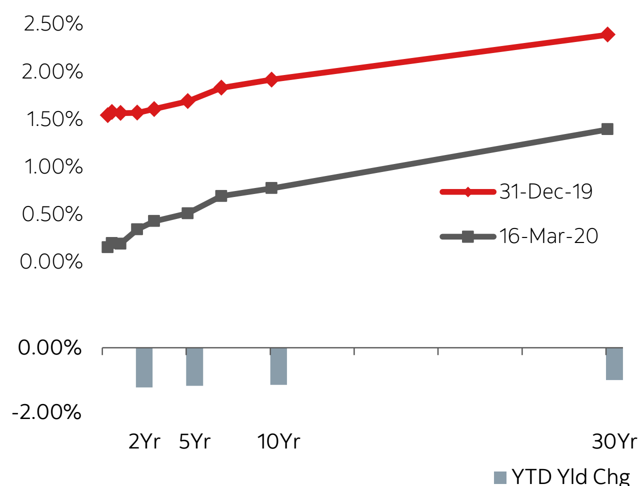
Figure 1: U.S. FOMC swiftly lowered rates to the Effective Lower Bound (ELB) amid COVID-19 outbreak



Sources: Scotia Wealth Management, Bloomberg

The introduction of a new quantitative easing program likely reflects dislocations in U.S. Treasury markets that surfaced last week. Despite unsettled financial markets, which normally would increase demand for haven assets such as U.S. government debt, driving their prices higher and yields lower, yields on U.S. 10-year and 30-year Treasuries migrated higher after reaching historic lows on March 9th. The FOMC's newly introduced QE4 program should help manage U.S. government bond yields. This is important given the crucial role debt markets - which take their cues from U.S. Treasuries - play in fulfilling U.S. corporate financing needs.

Figure 2: Yield curve uninverts on rate cuts, as yields touch all-time lows



Sources: Scotia Wealth Management, Bloomberg

Chairman Jerome Powell also provided strong forward guidance indicating that the U.S. central bank’s current policy mix would remain unchanged until the FOMC is confident that the economy has weathered recent events and is on track to achieve its statutory dual mandate. In the accompanying press conference, Mr. Powell reaffirmed that the bank was unlikely to employ negative interest rates to combat a worsening downturn. Instead, the Committee would rather rely on a combination of forward guidance and asset purchases. Ultimately, the significant reduction in activity and rising costs associated with the pandemic significantly increase the likelihood of a global recession. However, alleviating funding stresses through repo and asset purchases mitigates the risk of financial conditions tightening further. We expect further monetary and fiscal stimulus measures from other countries to be announced, creating a system of indefinite support until pandemic risks subside.

Conceivably, the FOMC could take other pages from its 2008 playbook to mitigate problems appearing in other corners of the debt market. Of note, the commercial

paper (CP) market has seized up, likely due to lenders concerned about the creditworthiness of borrowers in light of the current economic slowdown. CP is unsecured debt, typically with a term of less than 270 days, used by corporations to finance day-to-day expenses. In some sense, this market helps corporations "keep the lights on." During the 2008 financial crisis, this market came to a standstill. With corporations unable to draw on credit lines or tap bond markets, funding became precarious. To resolve the issue, the U.S. Federal Reserve implemented a Commercial Paper Funding Facility that allowed it to purchase this type of debt. Such a program could be implemented again, though doing so would require coordination with the U.S. Treasury.

In our view, the U.S. Federal Reserve is reacting appropriately to an exogenous threat that has brought the global economy to a halt in a very short period of time. We note that the 2008 financial crisis followed a ~2.5-year decline in U.S. home prices. This time around, it was a scant 2.5 months ago (at most) that the novel coronavirus started making headlines. Monetary authorities and governments are moving very quickly to avert crises on multiple fronts. While we expect this will lead to heightened financial market volatility in the weeks ahead, we are also of the view that the pandemic will eventually pass. The best course of action in times like these is to not panic, stay invested, and remain diversified. Equities, in particular, are likely to be whipsawed as investors grapple with the uncertain outlook. While companies with weak business models, material near-term financing requirements or limited cash flow will have a rough go of it, those with sustainable competitive advantages, net cash balance sheets (or debt that has been termed out), and strong cash flow should be able to navigate current conditions.

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