June 15, 2020

FOMC's Economic and Rate Outlook: A Long Road Ahead

Transcript

Bill Emmons: Hi, today is June 15 and I'm Bill Emmons. I'd like to talk to you about the FOMC meeting that took place June 9th and 10th. This was the first set of projections the FOMC has released in six months. And, not surprisingly, the FOMC sees a very long road ahead both in terms of economic recovery and the path of rates. So, the most important takeaways from the meeting, I think, include the FOMC's view, which is very consistent with virtually everybody looking at the economy right now, we are in a recession beginning in March. It is likely to be the most severe since World War II. The FOMC expects unemployment to remain near 10% even at the end of this year. The inflation rate is going to be below the Fed's 2% target for several years according to the FOMC. And the monetary policy actions that they took included maintaining the Fed funds target range at 0% to a .25%. Leaving the interest rate on excess reserves at 10 basis points, large scale asset purchases. Now there was a change here. Rather than tapering, which was the message from the last meeting. The Fed said that they will maintain the current rate of purchases. So, in a sense that's a little bit more aggressive easing. In terms of financial market policies, we've talked about this in the past, the Fed continues to operate about a dozen emergency funding credit, liquidity and loan facilities. These are specifically designed to address the financial issues we've been facing.

So, I want to focus on the projections that the FOMC released. So, the June 2020 Summary of Economic Projections, the so-called SEP was the first since December. That's because in March the emergency March 15 meeting preempted the regularly scheduled meeting for later that week. Given the turmoil, they chose not to release any projections at that time. So, the bottom line of these new projections is that this year, 2020, will be the worst for the economy since 1946. And looking forward, the road to recovery is long and very uncertain. So, some of the highlights, Real GDP, the best measure of overall economic activity is expected to decline 6.5% this year. As I've said in the past, this is more than twice as bad as the worst year of the great recession. The unemployment rate is expected to rise from 3.5% at the end of last year to 9.3% at the end of this year. Inflation is likely to run below 1% this year and then, in the next couple of years it's still below 2%, the Fed's target.

It's also interesting and not surprising that there was a wide range of views within the FOMC about what the economy will look like this year. So, looking at that projection of growth from the end of last year to the end of 2020, the range was -4% to -10%. So, there was at least one member of the FOMC who sees a 10% decline in the economy this year which would take us all the way back to the Great Depression type of decline. The unemployment rate range of estimates was between 7% at the end of this year up to 14%. And the inflation was a little bit more narrowly clustered around 1% this year.

So, I want to go through a couple of these important indicators and just show you how big the change has been since the end of last year. So, the December 2019 projections will serve as the pre-pandemic view from the Fed. First, in terms of what the economy would be doing. Growth at about 2%, each of 2020, 2021, and 2022. So, the top in each of these pictures, the blue line, will represent the projections as of December 2019 and these are the median FOMC members' projections. Then the orange line represents projections just released in June of 2020. So, first that 6.5% decline expected for this year followed by some recovery, 5% in 2021 and 3.5% in 2022. But given the huge decline this year, even those fast rates of growth won't get us back up to the path of what we were expecting before the pandemic. In fact, after this year, if this projection pans out, we'll be fully

8% below in terms of the level of the GDP of what we expected to be at the end of the year. And making up some ground in subsequent years but still, after the end of 2022, still 4% below where we thought we would be. So, that's several years' worth of growth right there. And in fact, the congressional budget office just released projections over a 10 year horizon. They think it will be fully 10 years before, in our picture here of the orange line, regains that blue path of potential output.

As for unemployment, the Fed was looking for, at the end of last year, basically no change, 3.5% unemployment. Maybe a slight increase over the following couple of years. But of course, now, with the pandemic, the huge disruption in the economy, you're looking for close to 9.5% at the end of this year, falling to 6.5% and then 5.5%. As you can see, it's going to be a relatively slow recovery back to these 3.5 % levels. So, if you think about at the end of this year, that 5.8% point, higher unemployment rate than we thought we would be facing as recently as December of last year, that translates into 10 million more unemployed people then we expected as of last December. And then looking forward, that's about 5 million more unemployed people than we expected at the end of 2021. And even looking out now 2.5 years, the FOMC is expecting 3 million more people to be unemployed than we thought would be the case before the pandemic hit. So, this illustrates, I think just how slow it's going to be according to the Fed view of getting back to where we thought we would be heading.

As for inflation, the FOMC was looking for close to 2% evolution of the price level or year over year change is inflation. Now, of course, we expect a lower path, less than 1% this year and then maybe 1.6%, 1.7% in the following years. And those shortfalls, of course, have cumulative effects and you probably have followed. Many of the FOMC members have been talking a lot in recent months and years about price level targets. So, trying to hit that blue line, essentially, over time. And this episode looks like we're going to be pushed further below. And in fact, the Fed has had difficulty even keeping up close to that 2% path for some years. So, this event is likely to push us even further down, a little bit further away from that desired 2% evolution of the price level.

And then, how does this translate into the policy rate? As of last December, the FOMC expected the rate to be basically unchanged at about 1.6% through 2020 and then, somewhat of an increase over the following years. That, of course, changed dramatically, the Fed cut the short-term rate, the target, close to 0% in March and that's where they expect it to remain all the way through the forecast horizon, through the end of 2022. So, it will be no sooner than 2023 before the Fed expects to lift rates off of 0%. And so, the short fall relative to the path of short-term rates that we expected, 150 basis points this year, rising to 180 and 200 basis points lower on the short end of the curve than we expected it to be as recently as December. And, of course, long term interest rates reflect that. The 10 year treasury dropping again recently back down below 70 basis points.

So, what are the implications for banks? There's no question, the economy is in a very severe recession. Many bank customers are likely to be negatively affected for several years. Financial markets remain volatile but they're functioning relatively well. Not least because of all of the support coming from the Fed. I think fears of a financial crisis, which increased in March, are at this point unfounded. I think the financial system looks solid at this point. And short-term interest rates are likely to stay near 0% into 2023 at least.

So, what can we expect? The pandemic remains the driver of economic developments, there's no question about that. And the Fed, obviously, is not the right agency to combat that directly. All we can do is play a support role. It's also the case that states in our district now are at the forefront of the epidemic. Confirmed cases are rising in Arkansas, Kentucky, Missouri, Mississippi, Tennessee and many other states, 20 to 25 states nationwide now have rising confirmed cases. Signs of economic recovery have appeared in various data

released like the employment report for May. But setbacks are likely as outbreaks arise. Bottom line, the Fed will continue to act aggressively to support financial markets and the economy because this is an extraordinary situation and the Fed is fully engaged. Thanks for listening and we'll see you next time.

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