August 3rd, 2020

FOMC's Economic and Rate Outlook: Economic Outlook Darkens As Virus Spread Continues

Transcript

Bill Emmons: Hi, I'm Bill Emmons. Today is Monday, August 3. I'd like to talk about the FOMC meeting that took place July 28 and 29. There wasn't a lot of new action from the FOMC. I think the dominant message was that the economic outlook has darkened as the virus has continued to spread. So the meeting takeaways included an unusual first paragraph.

The FOMC pledged to use its full range of tools to support the U.S. economy. That's a phrase that Chairman Powell has been repeating for several months. The Fed's economic outlook frankly is bleak. The virus, according to the FOMC, will weigh heavily on employment, spending, and inflation for some time. The very accommodative monetary policy, put in place in March, now is locked in until the recovery comes into sight.

As a reminder, that includes the Fed Funds target range between zero and a quarter percent, the interest rate on excess reserves at 10 basis points, and the program of large-scale asset purchases will continue. In a separate action, earlier in the week, the Federal Reserve Board decided to extend all of the emergency lending facilities through the year end, despite the fact that there has been limited usage of most of those programs.

So let me start, as Chairman Powell did, with the virus. That is absolutely the central focus of any discussion of economic recovery. I'll characterize the coronavirus as in charge and out of control. This is a picture that shows the United States compared to the other G7 countries. You could think of those as our peers internationally. These numbers are adjusted for population size, here expressed as number of daily new confirmed cases per million people. It's just moved over a seven-day average.

You can see over the last several months the United States has departed, our new case count has exploded, and we are still at about an 8% test rate, and that needs to be much, much lower before we can effectively say that we have a good handle on the testing situation. It is now again the case that more than 1,000 Americans are dying every day from COVID. This is as we saw back in the very early stages, but those counts are rising again.

And our district, which has been spared some of the worst of the early spread, now has become a hotspot. You can see, especially sort of moving from the south to the north in our district, very substantial case counts and deaths are piling up. So, as for the economy, there's emerging evidence that the recovery may actually be stalling. A lot of data to cover. I'll try to go through it quickly. In broad strokes, there was a strong bounce-back between about mid-April when the first stimulus payments came out to about late June.

But, even that strong bounce-back was not enough to overcome the catastrophic decline in March. So the change in real GDP for the second quarter was the worst on record. And then, as that period passes, it's no mystery what happened in June and early July. The virus began spreading again very rapidly, and it has caused consumers and businesses to retreat. So I'll provide you some information on all of these points.

And, as I said, the FOMC continues to cite the public health crisis as foremost in the economic outlook. Some of the real-time indicators, things that are coming in on a more timely basis than, for example, GDP, are suggesting that the economy may be flat-lining at this point. There's widespread softness. I'm not going to call it a renewed collapse. But that is a risk if the virus is not contained. And it really goes without saying, there's huge uncertainty about the extent of the pullback and where we go from here.

So these are the GDP numbers—just stunning, completely shocking numbers when you look at how large the decline was. So I'm showing here the real inflation-adjusted GDP, a change from the first to the second quarter of this year at an annualized rate of negative 33% t. That is to say, if that continued for a full year, we would have a 33% decline. Now, no one expects that to happen. So, probably a better way to think about this at this point is, where is this over the last four quarters?

And that number is about negative 9.5%. You may recall that the FOMC's forecast for the full year is a decline of about 6.5%. So that's suggesting that we need to grow a little bit faster than our potential growth rate even to get up to that number. The unemployment rate, which in the monthly report, which we think is much more reliable, that was still at about 11% in June. The July number will be out in the end of the first week of August.

We get more timely data in the weekly insurance claims reports, and its somewhat comparable measure for unemployment is the insured unemployment rate. And you can see those two do track each other fairly well, and the number through July 18 shows that there may have been some deterioration, that, in other words, unemployment may have ticked up a little bit in July.

My own view is that the July unemployment rate probably will be lower than June, but there is real danger that unemployment could begin to rise again in August unless there is some improvement. One of the indexes I've shown you before is from the New York Fed, again, using lots of different data sources to give a weekly update on where the economy is. And this is expressed in terms of the change from a year ago of real GDP. You can see at the worst point it was down 11.5%in late April.

The most recent number, again, shows this weakness, this potential stalling of the upward momentum, through July 25. This measure shows about a negative 7.2%. Another data source is using credit card and debit card spending information. So this is a measure of nondurables—that is, no autos in here, but a very large chunk of consumer spending. And this is calibrated to be equal to the level in January.

That's the 0%mark, that part of the chart. After the huge initial decline, we got some significant bounce-back in consumer spending, mostly around that April—the beginning of the payments. But you can see that that upward momentum stalled out in June and July. And now, for the last month or so, there's been no further increase, no improvement back toward that January 11 level.

Ticking down a little bit, transportation spending, for example airlines. Again, that upward momentum has stalled, and this level is now still 50% below what it was in January. Also for the category entertainment and recreation, that's down a little bit more than 50% from January. And you can see that upward momentum has stalled. Another measure is small business revenue—the same pattern. So we're seeing this across lots of different measures that the upward momentum seems to have more or less stopped in June or July.

Now, the Fed of course is active both in traditional monetary policy, interest rate changes and large-scale asset purchases. That's really represented by the red line here. This is the securities portfolio of the Fed, and this is benchmarked back to 2006, if you want to compare the current experience with that of the 2007, 2008, 2009 period. So the asset purchases have increased a lot. There's a big increase on the Fed's balance sheet from that source. The other piece are these emergency financing facilities. And those are captured in the blue line.

And the point here is that the increase in lending through these special emergency facilities has actually been fairly small, fairly limited, compared to the 2008 prices and compared to the percentage-wise increase in securities holdings. And in fact the level of Fed assets that came through these programs is falling pretty sharply.

So I think that's a real question that I think the Fed is thinking about. What is the role of these emergency facilities in the recovery?

I wanted to point to financial markets where we're really seeing some divergences. So the point I want to try to emphasize here is that the stock market and the bond markets really give us different types of information, complementary types of information. Sometimes it's easier to interpret than other times. In general, the historical pattern has been that, when stock prices go up, bond deals tend to go up.

So the dominant factor is a stronger recovery, which tends to push up corporate profits, tends to raise interest rates, either through Fed actions or just market-determined forces. And that was generally true. You can see the big decline, both in long-term interest rates and stock prices as the crisis really hit. But something kind of odd has emerged in the last month or two, and that's this very clear divergence. Stock prices continued to move higher, whereas long-term interest rates declined fairly substantially.

So this is a little bit odd. And if it's the case that these long-term interest rates are signaling a more pessimistic view of the outlook, either for economic growth or inflation or both, then what is it that's driving the stock market higher? Possibly the lower long-term rate is part of the discount rate. That is, the alternatives to stocks are looking less and less attractive. But it also could be that there's a very strong profit outlook for companies.

And that certainly could happen, but that's not what the forecasting community is looking for. What I'm showing here is a very long-term picture to try to make the point that stock prices, which is the S&P 500 here, the red line, generally track these larger magnitude quantities like GDP, which is shown in the green line, and more specifically, you would think corporate profits. So the after-tax corporate profit line is the blue line. So all three of those things track each other broadly over long, long periods of time.

But if you look at the last few years, and especially even in this year, there seems again to be this divergence, that stock prices seem to be, I would say almost disconnected from fundamentals. So if this forecast for corporate profits from macroeconomic advisors turns out to be anywhere near close to true, stock prices potentially have a fairly large adjustment to make to get back closer to those fundamentals. So, what are the implications for banks? I think that the economic recovery, of course, it's front and center.

And we are incomplete. The recovery has stalled, it appears, for the time being. Financial markets and financial institutions, including banks, at this point seem to be bright spots. Markets seem to be working well. Banks are functioning well. We're not concerned about banking problems, credit problems at this point. But the second half of 2020 could bring the reckoning that has been postponed by massive government bailouts in the first half, if no follow-through occurs.

And, as for the Fed actions, there's really no doubt in anyone's mind, I think, that the Fed is likely to keep interest rates pinned close to zero for the next couple of years, at least. So, what should we expect? Unfortunately, the states in our district now are at the forefront of the epidemic. We are a hotspot. So I think we also need to look for those increasing signs that businesses and consumers may be pulling back, that we will see more of that economic stalling going on in our region too.

Unless there is continued massive support from government, my own view is that defaults will increase sharply and soon. Now I think that there will be support from the Fed from the fiscal side, but that, unfortunately, is absolutely critical at this point. And, as stated at the outset, the Fed will continue to act aggressively to support financial markets and the economy using all the tools at our disposal. Thanks for listening, and see you next time.

(END OF RECORDING)