

Transcript

Bill Emmons: Bill Emmons: Hi. I'm Bill Emmons. Today is Friday, March 20th. I'd like to talk about the FOMC actions that have taken place in February and March, what I characterize as the FOMC deploying crisis era tools. And of course, as part of this crisis, we at the Fed are in a remote work, work-at-home stance, and obviously, that puts me not in our studio but in my home office.

Going back to the last FOMC meeting, which took place on January 28th and 29th of this year, at that point, there was no mention of the virus. Then the minutes of that meeting released February 19th. In those minutes, we can see that the participants in the FOMC meeting were aware of the risk but thought it was mostly outside the U.S. Then on February 28th in an unscheduled press release, Chairman Powell noted that the Fed is taking the virus risk more seriously. That was followed up the next week, March 3rd, with an unscheduled interest rate cut. At that point, the FOMC said the virus poses evolving risks to economic activity.

Then on March 15th, a Sunday, another unscheduled FOMC meeting, press release, and interest rate cut, this time at 100 basis points. At that time, the FOMC stated more clearly that the virus is damaging the U.S. economy and financial markets. After the Fed cut interest rates on March 15th, in just a matter of days, there was a string of other press releases and actions, encouraging banks to continue the flow of credit to households and businesses, mentioning that there will be coordinated central bank actions with counterparts around the world, to improve dollar liquidity, also the reestablishment of some crisis-era programs, the Primary Dealer Credit Facility and the Commercial Paper Funding Facility. Again, reiteration of the importance of banks continuing to work with their customers during this period.

So let's step back and think about what's happened in this last two months or even less than two months. The January 28-29 FOMC meeting, as I said, really gave no public signal there was anything seriously amiss. As I'll show, by the weekend, spanning February 21st, a Friday, to February 24th, a Monday, it was clear that some upsets were occurring in financial markets, what I call flight-to-safety trading, and that is the first serious implication that the virus was going to have a big effect on the economy and financial markets. As I mentioned, February 28th, the Fed made its unscheduled statement acknowledging those risks, and then followed up March 3rd with that 50 basis point cut in rates.

One way to think about the way the financial markets were functioning during this Phase 1 is that even as markets reacted, we saw higher-risk yields going up. In the picture here, the highest rated, non-investment-grade bond, the BB-rated bond, yields were rising pretty sharply. But at the same time, highly rated corporate bonds, the AAA, which is the line before that, and the 10-year Treasury, the risk-free bond yield, were going down. So what we saw, of course, was rising credit spreads. It's also the case, as the Fed cut interest rates, those trends continued, and we saw also, again, an inversion of the Treasury yield curve. A long-term yield here, the 10-year, went below the one-month for other short-term yields. These are classic flight-to-quality, maybe orderly reactions in markets, to heightened economic uncertainty and potentially higher recession risk.

The stock market, which had fallen pretty sharply at the end of February and early March seemed to stabilize, not necessarily only because of the Fed's cut of 50 basis points on March 3, but as people seemed to think things might be coming under control. But we then entered Phase 2, and I'm really locating that pivot point as

the weekend bracketed by March 6th, a Friday, and March 9th, a Monday. At that point, already before the weekend, and certainly coming out of that weekend, we saw widespread financial market disruptions, very unusual patterns in trading, lots of reports of poor liquidity or even some markets that were not functioning at all. It was also the case that the economic outlook was darkening as it became clear what a severe interruption we were going through in our economy. And as I'll show you, an index of economic policy uncertainty spiked. At the same time, an almost identical pattern, the volatility, that's sometimes called the fear gauge, or VIX in the stock market, also spiked up. Then by March 15th, that Sunday announcement, the FOMC made an unscheduled 100 basis point cut in the target range and announced in the next few days a whole range of emergency measures.

After the initial period of uncertainty, what I call the entry into Phase 1, this measure of uncertainty or risk in the short-term money markets showed very little change. This is the commercial paper rate and the T-bill rate. Those yields were very close together, and even after that emergence of flight-to-quality trading early in Phase 1, those yields didn't move much. But then as we moved into March, you can see that changed. As I characterized it, this pivot point seems to be in the March 6-9 period, that weekend, when short-term rates went down. It became very clear to market participants that the Fed was going to have to cut again and possibly all the way to zero, which of course happened, but at the same time, commercial paper yields, and again, these are AA-rated, very high quality commercial paper, those yields went the opposite direction, so you had a massive widening in the commercial paper spread. This was an indication that the financial markets are not working properly.

Going back to the longer-term interest rate market, the March 6-9 period really showed the rapid increase in junk bond yields, and, very odd pattern, the AAA Treasury yield also rose. As you can see, in just a matter of days, the AAA corporate bond yield rose over 100 basis points, which was a bizarre phenomenon at this point when the economic outlook is darkening. Also, the 10-year Treasury yield went up. That had the effect, as the short rate was falling, to steepen the yield curve again, which in normal times, would have been an optimistic view, but it seems implausible that the reason investors were pushing those yields up across the entire quality spectrum was that the economic outlook had improved. More likely is that these were the symptoms of financial markets that were struggling to perform.

Then on March 15th, the Fed cut rates by that 100 basis points, and early indications are that has not been enough to stem the tide. The financial markets are still in this pattern of poor functioning of markets and what appears to be uncertainty about where economic policy and of course the economy itself is headed. This picture of the stock market shows again that apparent stabilization in early March, the pivot point the weekend of March 6-9, and then very, very strong declines in the stock market. And, of course, this has been happening globally, and the Fed 100 basis point cut, at least to this point, has not been able to break that momentum.

Two indicators that point to this idea that in addition to difficulties functioning in the market, a gloomier outlook for the economy, but also a great deal of uncertainty about just what the responses will be are shown in this picture. The blue line is the well-known stock market volatility index, VIX. That started to rise during the entry into the first phase, but then took another strong leg up as we moved into this second phase. It's even clearer with the orange line, the index of economic policy uncertainty, that the second phase in the March 6-9 period, really raised the uncertainty to a new, higher level.

So what are the implications for banks? First off, I think we're back at the zero lower bound on short-term interest rates for a long time. It doesn't appear that we are going to get off this certainly in the next matter of

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months, and it could go further than that. Economic outlook across the country, indeed across the world, has deteriorated significantly. By virtually all observers' accounts, a recession is likely this year. In fact, there's some possibility it's already begun. As we slowly get the data coming in, it is quite possible that March will be the first month of recession. Of course, supervisors will be working with banks who in turn should be working with their customers to get through this period, really unprecedented for everyone. As I mentioned, communications are more important than ever before.

What should we expect? Well, as I've laid out this last two months, I think we will remain in what I'm calling Phase 2 of policy uncertainty until public health, fiscal, financial, and, perhaps least important of all, monetary policies are implemented that will contain the virus and bring normal functioning back to financial markets and the economy. The reason that I say monetary policy is perhaps the least important is that obviously, the virus cannot be attacked directly through financial, monetary means. There are other approaches, other policies, foremost the public health policy, which must be implemented. I think we should expect the severe challenges we're facing now to go on for months, not weeks, and I think it is important to remember that strong banks can be a source of strength for their communities and the nation. Now is the time when we need to see lots of leaders stepping up. Thanks for listening, and I'll see you next time.

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