The Fed’s Dilemma

On CNBC’s Squawk Box, former Fed Governor Kevin Warsh floated the idea of a coordinated emergency response by the world’s central banks over the weekend. At this point, it isn’t apparent who’d be on board with this bold response. Not only are Fed members unconvinced, but European Central Bank (ECB) President Christine Lagarde said on Thursday that she’d need to see a “long-lasting” shock first, adding that we have not reached that point yet. The ECB (even more so than the Fed) has little (if any) ammunition remaining to combat future recessions. So, the markets are screaming for rate cuts, but with policy extremely accommodative already, central bankers are afraid of making a bad situation worse. There’s no easy answer and no clear response.

Stock market investors have been conditioned over the last decade to expect the “Powell put” to bail them out, but this time is different. There’s no compelling reason to expect a series of rate cuts would have a positive effect on the economy. The Fed is already extremely low on ammunition. Keep in mind that the FOMC eased by more than 500 basis points to combat the last two recessions, and now has just 150 basis points to offer. With the U.S. economy weakened but still chugging along, Fed members are reluctant to act too early. Unfortunately, whatever policy decision is ultimately made will probably be wrong. The mistake is expecting central bankers to conquer the coronavirus.

In the Wall Street Journal’s “Heard on The Street” column this morning, James Lahart wrote “using monetary policy to counteract the economic effects of the coronavirus outbreak would be a bit like using a hammer to unscrew a bolt. But if a hammer is the only tool you have, you use it.” The article, titled “Fed Can’t Inoculate Economy” doesn’t effectively make the case for the Fed to act, although historically Fed officials have been quite accommodative in emergency situations. In market lingo, the “Powell put” refers to Fed Chairman Powell cutting rates to rescue the markets. With the virus creating havoc in the stock market, investors are hoping the Fed will cut on March 18th, but most Fed officials haven’t yet indicated a willingness to ease again after slashing the overnight rate target three times over a span of three months from July to October 2019.

The U.S. bond market, one of few safe havens during the panic, has already priced in another three cuts for 2020. Fed funds futures are now indicating the first of these cuts will happen in less than three weeks. However, the vice chairman of the FOMC, Richard Clarida, made it clear on Tuesday that the committee had no immediate plan to cut rates, saying it’s “still too soon” to determine the impact the coronavirus will have on the United States. Clarida, in a speech to the National Association for Business Economics said that “as long as incoming information about the economy remains broadly consistent with this outlook, the current stance of monetary policy likely will remain appropriate.” Although there’s a wide range of opinion among Fed members, Clarida isn’t alone. This morning, St. Louis Fed President James Bullard acknowledged that “further policy rates cuts are a possibility if a global pandemic actually develops with health effects approaching the scale of ordinary influenza, but this isn’t the baseline case at this point.” The Fed will almost certainly be forced to cut. When and by how much are the questions.

Market yields continues to tumble along with stocks. The 10-year Treasury yield is now at 1.15%, a shocking half point drop in two short weeks.
Market Indications as of 12:55 P.M. Central Time

DOW                  DOWN 859 to 24,909 (HIGH: 29,551)
NASDAQ            DOWN 200 to 8,366 (HIGH: 9,817)
S&P 500             DOWN 86 to 2,892 (HIGH: 3,386)
1-Yr T-bill         current yield 1.00%; opening yield 1.14%
2-Yr T-note         current yield 0.92%; opening yield 1.06%
5-Yr T-note         current yield 0.94%; opening yield 1.07%
10-Yr T-note        current yield 1.15%; opening yield 1.26%
30-Yr T-bond       current yield 1.66%; opening yield 1.76%