Weighing the Cost of Additional Cuts

After shedding more than 3900 points or -13.4% in seven trading days, the DOW has rebounded sharply, gaining back over 1000 points. Other major indexes are experiencing a similar upward movement. The reason for the rally is the widely-held belief that Fed officials are suddenly willing to rescue the floundering U.S. stock market. It isn’t clear how a rate cut or a series of rates cuts will bolster domestic economic growth in the face of a global virus outbreak, but the market carnage has been severe, and central bankers are the only available fix. Fed funds futures are now indicating a 100% chance of three rate cuts and a 40% of a fourth cut by December 16, 2020. Given statements by several Fed officials last week signifying a preference to wait-and-see, aggressive cuts don’t exactly fit the narrative. Fed Chair Jay Powell apparently succumbed to pressure on Friday, pledging to “act as appropriate to sustain the expansion,” but this standard Fed line isn’t anything new. The dot plot from the December FOMC meeting indicated no change in monetary policy for all of 2020 and most of 2021, with the next move being a rate hike. Although since rendered meaningless, it does illustrate the Fed’s intent to eventually tighten policy, not loosen it.

Fed rate cuts would appease the stock markets for a time, but as long as the virus threat remains intact, U.S. businesses aren’t going to invest, consumers aren’t likely to borrow, and U.S. factories still won’t have access to Chinese materials and parts. Nothing happens, except a temporary reinvigorating of the stock market. If the threat worsens and the U.S. economy weakens, more public events will be canceled along with flights, and very soon the equity markets will be clamoring for more and more cuts. When concrete signs of economic slowing eventually emerge, the Fed will have already depleted its monetary policy options. That’s why it’s hard to imagine the Fed cutting three or four times this year. The FOMC simply don’t have the capacity and there’s little reason to imagine easing will accomplish the Fed’s objective (presuming it isn’t to prop up the stock markets). As investors contemplate the Fed’s next move, it’s even less clear whether a successful repelling of COVID-19 would allow the Fed to quickly reverse its emergency cut(s).

Late last week, the official Chinese purchasing managers’ index (PMI) dropped 14.3 percentage points from 50 to an all-time low 35.7. This level is consistent with recession. Bloomberg News now believes Q1 GDP growth in China will plunge from +6% to +1.2% year-over-year, a shocking -3% contraction on a quarter-over-quarter basis. Although investors have focused their attentions on Chinese factories, the global impact of a billion hibernating Chinese consumers will be severe. U.S. multinational companies rely heavily on these Chinese consumers, and the stock market reflects this concern. The Fed can’t bring these consumers back to the mall any more than they can reopen shuttered factory doors.

Please see disclosure on page 2.
Market Indications as of 2:50 P.M. Central Time

DOW                  Up 1,097 to 26,506 (HIGH: 29,551)
NASDAQ            Up 313 to 8,881 (HIGH: 9,817)
S&P 500             Up 92 to 3,046 (HIGH: 3,386)
1-Yr T-bill current yield 0.92%; opening yield 1.01%
2-Yr T-note current yield 0.91%; opening yield 0.91%
5-Yr T-note current yield 0.94%; opening yield 0.94%
10-Yr T-note current yield 1.15%; opening yield 1.15%
30-Yr T-bond current yield 1.70%; opening yield 1.68%