March 4, 2020

The Fed & Coronavirus

On the morning of March 3rd, the Fed cut its target Fed Funds rate in an emergency session. In a statement, the Fed said "The coronavirus poses evolving risks to economic activity. In light of these risks and in support of achieving its maximum employment and price stability goals, the Federal Open Market Committee decided today to lower the target range for the federal funds rate by ½ percentage point."

We are not going to state that we know more about the coronavirus than anyone else. Nor are we going to claim that this ½ percentage point cut will suddenly boost economic activity. Consumers are no more likely to hop on the plane than they were before. Nor will banks be more eager to lend to businesses. So what's going on here?

Although we and many others have believed for some time that the Fed was taking its cues from the stock market, our observation is that this is now ever more so the case. We believe that the Fed has acted so quickly in direct response to the February stock market correction. Presidential pressure may have added to this impetus and we can debate whether the President has been influenced by the markets as well. But we firmly believe that there would not have been such an emergency decision if it weren't for the direct role of the equity markets.

Having said this, is there any benefit to the economy as a whole? We would argue that the answer is yes, but not in a direct manner. We believe the Fed, while taking its cues from the equity markets, is attempting to prevent the fixed income markets from seizing up. Going back to the Great Recession, the financial markets seized up as a result of the bond markets seizing up. Yes, there was a housing crisis, but companies such as Lehman Bros. and AIG didn't fail because their assets were no good. They failed because they couldn't secure short-term financing to support their asset positions.

So the coronavirus is a risk to the economy in most ways you would presume. It will impact supply chains and consumer activity. But we presume eventually there will be vaccinations and cures, and this virus will likely eventually become a manageable problem. Economic growth in the interim will be slower than it would have been otherwise. Still, the economy can withstand such a slowdown.

But the real risk is that in a leveraged economy, banks and other financial institutions horde their cash and refuse to fund short-term liquidity needs. In such an environment, bankruptcies can accelerate fueling a downward spiral leading to another massive economic slowdown.

The Fed, in our opinion saw the stock market correction as a signal that all financial markets may be seizing up. To that extent they have stepped in and have signaled they will do all they can to avoid a repeat of the 2007 through 2009 period.

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