

## Federal Reserve: All in

UPDATE: Fed cuts rates on Sunday by 100 bp to virtually zero. This article was published just three hours before the announcement.

In an effort to support the economy and stabilise markets, we believe the Fed will go “all in” and cut the fed funds target rate to 0-0.25% and officially start QE4 on Wednesday



Fed Chairman, Jerome Powell

### Whatever it takes

Wednesday is shaping up to be the Federal Reserve’s “whatever it takes” moment. The economic and financial market situation demands they “go big”. To not respond meaningfully would risk a reaction that makes an already intense and somewhat dysfunctional situation significantly worse. We look for a 100bp interest rate cut with an “official” restart of quantitative easing – QE4 – of the order of US\$50-75bn per month.

### The economic case

Few analysts now doubt that the US is in recession. After a positive start to the year, the fear and disruption caused by Covid-19 has led activity to plunge through March with the pain spread across multiple sectors. The supply crunch in manufacturing, the panic in the financial sector and the collapse in airline travel, hotel stays and leisure activities means we could see a quarterly contraction of the scale reached during the height of the financial crisis. We are pencilling in a greater than 7% annualised 2Q20 GDP decline relative to the -4.4% figure experienced in 1Q09 and

-8.8% in 4Q08.

There is also a high probability that the US experiences negative headline inflation during the second quarter and through the second half of the year with the plunge in oil prices already translating into steep declines in the cost of gasoline. Any prospect of a meaningful pick-up in wage growth is now gone with the clear threat that we start to see payrolls slide as company finances are squeezed by falling demand and tightening credit conditions.

## The credit case

It was clearly a turbulent week for markets as underlined by the fact at one point we were seeing both risk assets and safe havens, such as Treasuries and gold, sell-off as participants scrambled for liquidity. The Fed's willingness to inject US\$1.5 trillion at 1-3 month tenors has addressed some of the near-term stress in financial markets, but issues remain. The NY Fed also changed the way it manages the US\$60bn of reserve management purchases away from Treasury bills towards longer tenor issues. The Fed's decision to aggressively front load them – US\$37bn on Friday alone – underlines the strains. Given the uncertain prognosis for Covid-19 and its longer-term economic implications those stresses are unlikely to disappear.

Last week's huge liquidity injections underlined the Fed's willingness to aggressively deal with "temporary distortions" and this week we expect to see them unleash their full armoury. While there may be some push back from certain Fed officials, we believe the FOMC will choose to act decisively with a formal restart of "true" quantitative easing.

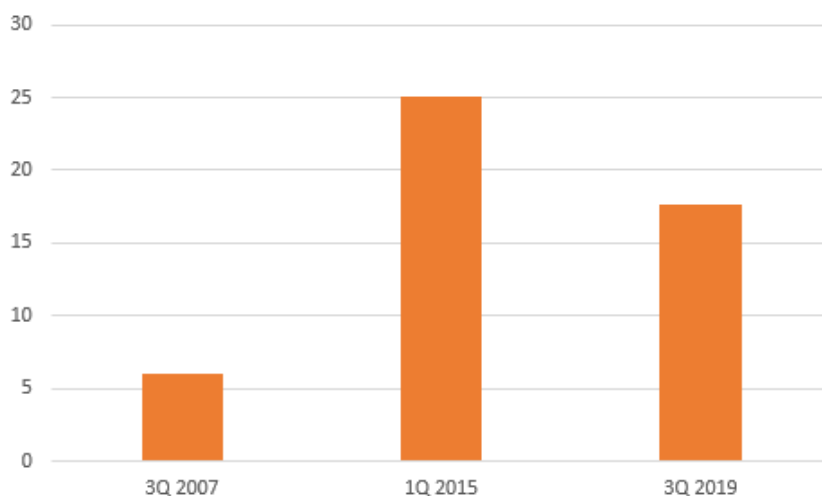
## The Fed's double bazooka – 100bp and US\$75bn per month QE

The Fed will be wary of disappointing expectations in this time of huge uncertainty on the basis that it could lead to a tightening of financial conditions that compound the downside risks to growth and inflation. Financial markets are already pricing interest rates at zero by April and to us there seems little point in waiting. Consequently we favour a 100bp move in the Fed funds target rate to 0-0.25% with interest on excess reserves cut to zero.

In terms of quantitative easing, QE 1 in 2008/09 was around US\$30bn per month of asset purchases while QE3 went up to US\$85bn per month from December 2012. We expect the Fed to start QE4 in the range of US\$50-75bn, favouring the higher end of that range. Moreover, the Federal Reserve's balance sheet peaked at US\$4.5 trillion in early 2015 – equivalent to around 25% of US GDP. Today the balance sheet is around US\$3.8 trillion or 18% of GDP. The Fed would have to expand its balance sheet by around US\$1.6 trillion to get us back to a 25% of GDP today, so there is plenty of ammunition.

The purchases will likely focus on Treasuries, but could also include mortgage backed securities given the recent spike in mortgage rates (around 60bp in the space of two weeks). Mortgage rates had plunged in the wake of falling bond yields, which triggered a sharp increase in the demand for mortgage refinancing and subsequent issuance of MBS. The recent dislocation in markets means participants are reluctant to absorb the extra MBS – hence the spike in yields now. The mortgage market is a key transmission mechanism for Fed stimulus so asset purchases may be required here.

## The size of the Fed's balance sheet - % of GDP



Source: Federal Reserve, ING

## The end result

This action in itself is not going to rescue the US economy from recession, but it will help to mitigate the risks from financial tensions that could make the growth and jobs outlook far, far worse. It will also offer breathing room before an anticipated fiscal stimulus and a potential lending scheme provided by the Treasury materialise. That said, only better news on the prognosis for Covid-19 will return us to “normality”. Like most, we hope this will be over by the summer, but the Fed cannot take that for granted and consequently this justifies an aggressive response that can always be reversed.

## Author

### James Knightley

Chief International Economist, US

[james.knightley@ing.com](mailto:james.knightley@ing.com)

## Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. (“ING”) solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies)*. The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom

this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit <http://www.ing.com>.