The Fed's cautious optimism

The Federal Reserve has released a broadly positive assessment on the US economic outlook, but they caution that the coronavirus and elevated asset valuations and corporate debt levels provide challenges

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A strong platform for growth

The Federal Reserve has released its semi-annual Monetary Policy Report, which is part summary of what has happened in the economy, part summary of the risks to the economy going forward and part summary of how they view the functioning of monetary policy and its framework.

The key aspects are the forward-looking views and in this regard it is a fairly upbeat assessment for the economy with an acknowledgement that the recent concerns about coronavirus means we can't take anything for granted.

The Fed suggest that downside risks to the economy "have receded" through late 2019 as trade conflicts diminished, fears of a disorderly Brexit subsided, financial conditions eased and external growth showed signs of stabilizing. As a result, the "global slowdown in manufacturing and trade appears to be nearing an end".

They also emphasized that the US financial system is "substantially more resilient" than before the global financial crisis with leverage in the financial sector appearing "low relative to historical norms". Given the three rate cuts and the liquidity injection that they implemented there is again the confidence that the economy is on a firmer footing, implying that there is little need for any further adjustment to monetary policy, at least in the near-term.

But risks remain...

Nonetheless, the Fed have flagged up a number of issues that they are closely watching. "Possible spillovers from the effects of the coronavirus in China have presented a new risk to the outlook" while the Fed also noted that "levels of business debt continue to be elevated" with the "riskiest firms accounting for most of the increase". They also comment that "asset valuation are elevated", which perhaps hints a little nervousness over what could happen to risk assets if the economic impact from the coronavirus becomes more of a global issue.

Fed Chair Jerome Powell will deliver his testimony to the House and the Senate next week where he will be questioned on his views, but they will not deviate from the main thrust of this report.

A bias to lower rates

The recent economic data clearly suggests that the US has started the year on a strong footing. Nonetheless, the threat that the coronavirus poses in an environment of still subdued global growth underlines the potential for medium-term US economic weakness. It is impossible to forecast the path of the virus, but the likely damage to US-Asian supply chains, distribution and of course Asian demand for American made products means there is a strong chance that the Fed will cut rates at least once more to provide some support to the economy. Markets continue to price one rate cut by the November 5 FOMC meeting.

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