US: The pressure to act

With both growth and inflation likely to plunge into negative territory in 2Q20 the calls for more stimulus will inevitably build. Only better news on the prognosis for coronavirus will combat the fear factor, but targeted measures can provide relief

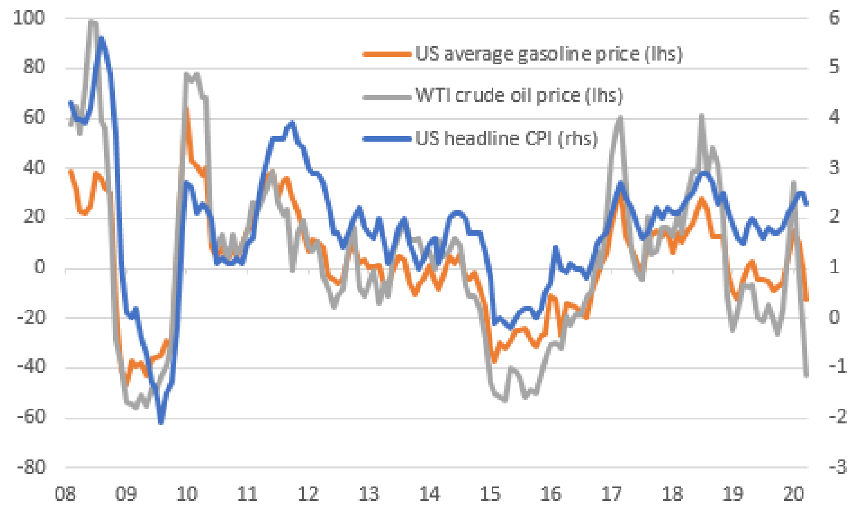
Source: Shutterstock

More economic pain to come

With a combination of precautionary measures and fear leading to major changes in consumer and business spending behaviour, we expect to see a negative GDP growth print for 2Q20. Leisure spending, eating out and hotels and travel sectors are obviously feeling pain while there is also the hit to sentiment from the plunge in equity markets that could translate into broader spending weakness. Trade will also be severely impacted with exports likely to fall in response to weaker global demand while business caution and disrupted supply chains will likely lead to a pullback in investment that could last into the third quarter.

Today's inflation numbers showed headline CPI running at 2.3% year on year and core at 2.4% YoY, but given oil prices are now down 45% YoY and gasoline prices are down 13% YoY already, this will be more than enough to drive headline inflation into negative YoY territory in 2Q20. Core inflation is also likely to move lower as weaker aggregate demand prompts a fight for customers, especially in the consumer services sector, while weaker employment growth will diminish the prospect of a pick-up in wage growth.

US inflation set to turn negative



Source: Bloomberg, ING

Where next for monetary policy?

Last week's 50bp interest rate cut from the Federal Reserve will in itself not trigger a meaningful boost to aggregate demand – only better news on the prognosis for the virus can do that – but it may help to mitigate some of the strains in the economy and financial system.

We suspect further policy moves are likely with financial markets already fully pricing in an additional 75bp of rate cuts next week from the Fed with a strong likelihood we will be back testing the lower bound of 0-0.25% at some point in April. While many in the Fed would like to push back against such action, the Fed will also be wary of disappointing those expectations on the basis that it could lead to a tightening of financial conditions that compound the downside risks to growth.

There is also the prospect of some form of quantitative easing if financial market distress returns. However, the stimulatory impact of Treasury purchases seems limited given bond yields are already so low – the 10Y Treasury yield is 100bp below the levels reached during the Global Financial Crisis. It would probably make more sense to implement targeted liquidity/credit measures in coming months, similar to what the Bank of England announced today, given the possibility of more distress in high yield markets and concerns about access to credit for small- and medium-sized firms.

And fiscal policy?

Increasingly, markets are focused on how fiscal policy can provide support. We already have the US$8.3bn spending package that President Trump signed last Friday, funding vaccine research and preventative efforts to combat Covid-19. In recent days President Trump has put forward the case for a payroll tax holiday through to the 3 November election.

President Obama introduced a one-year, 2 percentage point cut in payroll taxes for employees in 2010, which meant an extra US$120bn stayed in workers pockets – roughly amounting to US$1,000 for those households earning the median income at the time. However, it is questionable how effective such a move would be in dealing with the current situation and their certainly appears to be reluctance to go down this route in Congress.

Employees and employers currently each pay 6.2% tax on every workers' pay up to US$137,700 with a further 1.45% paid to fund Medicare. A payroll tax cut would last eight months and it would be spread out over each paycheck. It would of course disproportionately benefit the wealthy and arguably provide no benefit to those most vulnerable – the elderly who are retired while those out of work would receive no relief. Then there is the issue that the payroll tax is there to fund the social security program, which is obviously under strain. It would therefore put more pressure on general government borrowing, which has already ballooned to 5% of GDP per year despite the US economy having experienced the longest economic boom on record.

Instead, targeted financial support is likely get more bang for its buck, such as temporarily loosening the conditions required to qualify for welfare benefits– you often have to be available (and looking) for work to qualify, but that may not possible given Covid-19. We could also see temporary higher payments to affected populations and with the risk of broader school closures spending may be required to address the issue of nearly 30 million school children who receive free/subsidized meals. There is also the expectation that we see support to heavily disrupted businesses such as being able to delay or defer some tax payments plus the potential for business grants or lending facilities to help tide small firms over until the crisis fades.

We will wait to see what happens, but with the number of recorded cases of Covid-19 continuing to build the pressure for concerted fiscal and monetary action will also grow.

The fiscal deficit already looks fundamentally weak

Source: Macrobond, ING

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