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Fed cuts rates and oil prices plunge as virus spreads and OPEC+ pact crumbles

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Highlights

- **Financial markets have been hit hard by the spread of the coronavirus and its likely economic impact, with US equities down 10% in February, treasury yields hitting record lows and oil prices plunging helped by OPEC+'s inability to agree supply cuts.**
- **The Fed delivered an emergency 50 bps rate cut and could cut again at its official meeting in mid-March. US economic data has so far been reasonably positive, but is likely to weaken as the impact of the virus filters through.**
- **In Europe, the fallout has focused mostly on Italy where the cases have been most numerous and a recession seems likely this year. The ECB is likely to follow the Fed and announce further policy loosening at its March 12 meeting.**

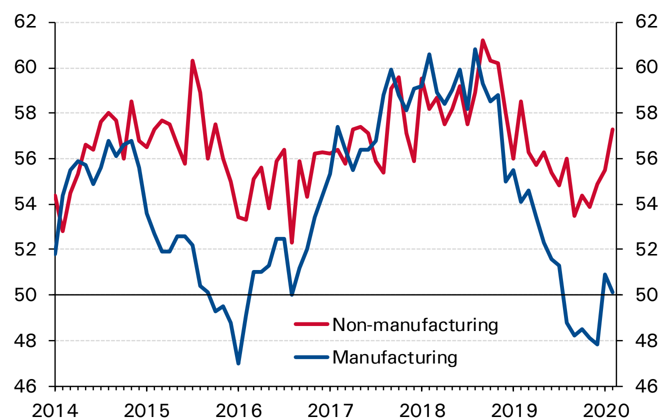
A turbulent February saw financial markets hit hard towards the end of the month by the spread of the coronavirus and its likely economic impact. US equities were down up to 10% m/m amid huge volatility, eventually prompting the Federal Reserve to announce an emergency 50 bps interest rate cut on March 3. Other markets were also affected, with US 10-year treasury yields plunging to a record low of 0.5% in early March as pessimism over global growth increased, while Brent oil prices collapsed to $32/bbl, 46% below mid-February levels. The IMF said it now expects global growth to be weaker this year than the 2.9% recorded in 2019, implying at least a 0.5% downward revision to its previous forecast of 3.3%, and pledged $50 billion in funding to help poorer countries fight the epidemic.

Fed delivers emergency rate cut

Economic data in the US has been largely positive – although there is expectation that indicators will weaken as coronavirus fallout filters through over coming weeks. The ISM manufacturing activity index edged back to 50.1 in February after jumping to 50.9 in January but remained in positive territory despite reports of supply chain disruptions. (Chart 1.) More impressively, the non-manufacturing equivalent leapt to a one-year high of 57.3 from 55.5 in January, raising some questions over whether fears about the virus's economic impact may be overblown. Employment growth also came in at a very robust 273,000 in February, unchanged from January, and the unemployment rate ticked down to 3.5% – though this strength is unlikely to be sustained given recent events.

Given the uncertainties, it is still too soon to properly judge the impact on US economic growth. Nowcast estimates peg growth running at an above-2% pace so far in 1Q20 – similar to 4Q19, but mostly reflecting pre-virus effect indicators. The OECD revised down its 2020 US growth forecast by 0.1% to 1.9% in early March, but said growth could slow by more if the virus spread intensifies. Meanwhile, there is talk that the US could suspend tariffs on Chinese imports to help cushion the growth impact of a worst-case virus-spread scenario, with implementation of the 'phase one' trade deal and bilateral talks on 'phase 2' already likely to be delayed.

Chart 1: US ISM activity surveys
(index, 50=no change)



Source: Refinitiv

Citing "evolving risks to economic activity", the Federal Reserve took the emergency step of slashing interest rates by 50 bps two-weeks before its scheduled March meeting, leaving the policy rate at 1.00-1.25%. It also promised to "act as appropriate to support the economy" and futures markets expect a further,

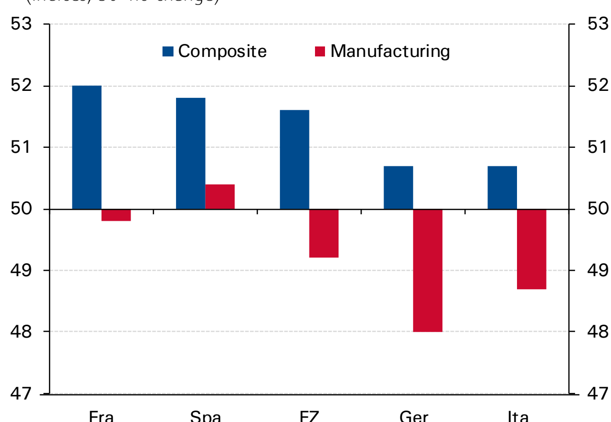
smaller reduction later in the month. While the Fed admitted that the cut cannot directly address virus-induced problems such as supply chain disruptions or travel restrictions (and therefore could be of limited effectiveness), it should help to loosen financial conditions. The yield on 10-year government bonds for example fell to a record low of 0.5% in the days after the cut, which will feed through into lower mortgage rates and support the housing market. And expectations of lower rates have pushed down the trade-weighted dollar 4% since mid-February, though the dollar remains at an historically strong level.

Italy reels from virus, ECB ready to loosen policy

In the Eurozone, the focus of the virus impact has mostly been on Italy where cases have been most numerous and resulting in the lockdown of the entire northern Lombardy region and concerns in particular about the important travel & tourism sector, worth around 13% of GDP. While the composite Italian PMI for February held up well at 50.7 (January 50.4), the impact on 1Q20 GDP is expected to be large with a recession this year now looking likely after modest growth of just 0.3% in 2019. (Chart 2.) The government announced €7.5 billion (0.4% of GDP) of fiscal stimulus (including tax credits and extra health spending) to fight the virus and the EU has agreed to disregard the impact on the budget deficit, which is now likely to breach the previously-approved threshold of 2.2% of GDP.

Chart 2: Eurozone PMIs for February 2020

(Indices, 50=no change)



Source: Refinitiv

The Governing Council of the European Central Bank (ECB) will meet on March 12 and unlike the Fed the bank looks set to wait until then before announcing any change in policy. However ECB president Christine Lagarde said in a statement before the Fed's move that the bank "stands ready to take appropriate and targeted measures" to address the virus fallout. Although with its policy deposit rate already negative at -0.5% the bank's room for maneuver on rates is limited, pressure to act will be considerable given already weak growth and now upward pressure on the euro which could hurt exports. It could look to other support mechanisms such as extending its program of cheap loans ('TLTROs') to encourage bank lending, or facilitating loans to small firms facing liquidity shortages.

Meanwhile the Bank of England could deliver an emergency rate cut before its scheduled meeting on 26 March. There may also be some new fiscal stimulus measures announced by recently-appointed Chancellor Rishi Sunak at what was already expected to be an expansionary Budget on 11 March, including extra spending on health services and on northern regions that were central to the governing Conservative party's decisive December election win.

Japanese economy contracts sharply in Q4 on tax hike

Japan's economy witnessed its weakest growth rate in over five years in 4Q19, contracting by an annualized 7.1%, sharply lower than the 0.1% expansion in the previous quarter, as the weakness in the external sector was compounded by the effects of the sales tax hike in October. Indeed, both exports and imports continued to fall in January, with exports down 2.6% y/y (the 13th consecutive month of decline) and imports slipping 3.5%. The coronavirus outbreak which has led to widespread supply-chain disruptions is likely to weigh on trade and ultimately economic growth going forward. That said, the finance minister vowed to implement fiscal stimulus measures if need be, to mitigate the effects of the outbreak. Furthermore, the governor of the Bank of Japan announced that the bank will strive to ensure that there is ample liquidity in financial markets by adopting "appropriate market operations and asset purchases".

Chinese economy paralyzed by outbreak

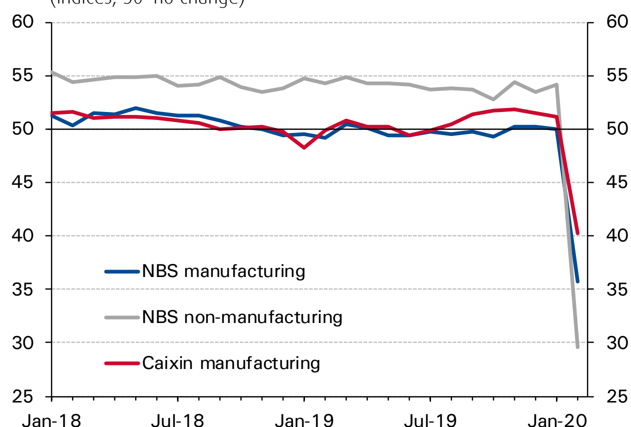
The death toll in China from the coronavirus outbreak topped 3,000 by early March with more than 80,600 confirmed cases. Though the number of new cases in China has reportedly slowed, the outbreak has continued to weigh heavily on economic activity, both due to supply-side disruptions (as firms were forced to shut or cut back on production) and demand-side disruptions (amid extended quarantine periods and restricted travel). The official PMI for February showed manufacturing activity plunging to a record low of 35.7 from 50 in January. (Chart 3.) The private (Caixin/Markit) manufacturing PMI also fell to a record low of 40.3. Meanwhile, both the official and private services PMIs also collapsed, to 29.6 and 26.5 respectively. The IMF cut its 2020 growth forecast for China by 0.4% to 5.6% and the OECD lowered its forecast from 5.7% to 4.9%.

A slew of stimulus measures over the past month are aimed at supporting economic activity. The ministry of finance announced cuts in social security and corporate taxes and fees, and the central bank reduced its one-year medium-term lending facility by 10 bps to 3.15% in a bid to lower long-term borrowing costs. This was followed by a 10 bps cut in the benchmark one-year loan prime rate to 4.05%. Additionally, the government has so

far allocated RMB90 billion to combatting the virus, on top of liquidity measures by the central bank. Meanwhile, the yuan depreciated by 1.7% to push past RMB7/$1 by the end of February, though subsequently recovered to RMB6.93/$1 in early March helped by dollar weakness.

Chart 3: Chinese PMIs

(indices, 50=no change)



Source: Refinitiv

Indian GDP growth improves modestly in Q4

India's economy grew by 4.7% y/y in 4Q19 (Q3 of fiscal year 2019/20), a modest rise from a six-year low of 4.5% in the previous quarter but in line with expectations. The pick-up was driven in part by a marginal improvement in private consumption, coupled with a sharp contraction in imports (likely due to recently imposed tariffs). Other components of GDP continued to be weak, especially investment which fell at its sharpest pace (-5.7%) since the financial crisis. Tight credit conditions and bad debt have impeded lending, and may continue to weigh on growth going forward.

More recently in February, the services PMI rose to the second strongest level since 2013 at 57.5 (55.5 in January), easily beating expectations. The manufacturing PMI also beat expectations despite a modest drop from to 54.5 from 55.3 the previous month, and suggesting an improvement in business conditions compared to the fourth quarter. Looking forward, the expectation is that economic growth will pick-up in FY2020 to 5.9%, though the improvement will likely be constrained by ongoing tightness in credit conditions as well as coronavirus-related downside risks on demand and exports. The virus count in India was a relatively low 40 cases as of March 8 with diligent screening and preventative measures in place by the authorities.

Oil prices plunge on virus worries, OPEC+ inaction

Oil markets have also been hammered by the coronavirus outbreak, dropping firmly into correction territory over the last few weeks. International benchmark Brent, having dropped more than 13% in February, plunged by more than 9% in one day on Friday 6 March then an astonishing 29% in Asian trading on Monday 9 to just $32/bbl – its lowest since January 2016 – after the OPEC+ meeting wrapped up without an agreement between Russia and Saudi-led OPEC. (Chart 4.) OPEC had earlier suggested deepening production cuts by an additional 1.5 mb/d to support oil prices that were reeling from the impact of the virus on Chinese and global oil demand. But Russia, with one eye on preventing further market share losses to US shale producers, preferred extending the existing cuts to June.

Chart 4: Brent crude oil price*

($ per barrel, end of month)

Source: Refinitiv * Latest figure shown is for March 9 (Asian trading)

The market sell-off was severe, the steepest since the financial crisis, as it augured not only the formal ending of the three-year Saudi-Russia supply management alliance but also the existing production cut agreement, which was due to expire in March pending a renewal. As of April, oil producers will be able pump at will, raising the prospect of an aggressive price war for market share. Saudi Aramco appears to have fired the first shot, signaling that it will discount the official selling price of its crudes by the most in at least twenty years. With global oil demand significantly impaired, already-saturated oil markets are likely to tip further into imbalance. OPEC revised down its estimate of global oil demand growth in 2020 for the second time: growth is now pegged at 480 kb/d, a whopping reduction of 56% from last December's forecast of 1.1 mb/d. Some energy houses are even expecting demand to contract in 2020, which would be the first time that would happen since the financial crisis and only the fourth time in almost forty years.

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