March 4, 2020

ECONOMIC REPORT

Gus Faucher Chief Economist | **Stuart Hoffman** Senior Economic Advisor | **William Adams** Senior Economist | **Kurt Rankin** Economist | **Abbey Omodunbi** Economist

THE PNC FINANCIAL SERVICES GROUP | The Tower at PNC Plaza | 300 Fifth Avenue | Pittsburgh, PA 15222-2401

FOMC CUTS RATES BY 0.5 PERCENTAGE POINT IN RARE INTERMEETING MOVE; LABOR MARKET SOLID IN FEBRUARY

SUMMARY

- In a surprise move the FOMC made a rare intermeeting fed funds rate cut in response to the COVID-19 outbreak, reducing the rate by 0.50 percentage point.
- The fed funds futures market expects further rate cuts in the months ahead.
- Stock prices fell in the aftermath of the emergency rate cut.
- Private-sector employment rose by a solid 183,000 in February, according to the ADP employment report. PNC expects job growth of 140,000 when the federal government jobs report is released on February 6.
- Although the U.S. job market was in good shape in early 2020, that was before the COVID-19 outbreak started to drag on the outlook.

The Federal Open Market Committee cut the fed funds rate by one-half of a percentage point at 10 AM on March 3, lowering the rate to 1.00 to 1.25 percent. The statement announcing the decision said that “the fundamentals of the U.S. economy remain strong. However, the coronavirus poses evolving risks to economic activity.”

The FOMC is scheduled to meet March 17 and 18, but the FOMC decided to act ahead of the meeting, at least partially in response to the big drop in U.S. equity markets the week of February 24, record-low yields on long-term US Treasuries, and the recent inversion in the yield curve. Intermeeting rate cuts are more likely to take markets by surprise, and therefore can provide a bigger bang, although they can also exacerbate panic. This was the first intermeeting cut to the fed funds rate since October 2008, and the first cut of more than 25 basis points since December 2008; both of those moves were during the financial crisis, when the FOMC eventually reduced the fed funds rate to a 0.00 to 0.25 percent range (see Chart 1).

The FOMC’s work is likely not done. As of midday on March 4 the fed funds futures market is pricing in no action at the FOMC meeting on March 17-18, but a 73 percent probability of a 25 basis point rate cut at the FOMC’s subsequent meeting, on April 29. The market expects the fed funds rate to be in a range of 0.25 to 0.50 percent at the end of 2020.

Stock prices initially jumped in response to the surprise announcement, but the S&P 500 ended March 3 down 2.8 percent for the day, and down 10.0 percent from the close on February 21. However, U.S. equity prices are up about 2 percent in early trading on March 4.

Yields on short-term Treasuries fell in the wake of the FOMC announcement, and have fallen further by midday on March 4. The yield on a 3-month Treasury bill was 0.67 percent at early afternoon on March 4, its lowest in three years, when the FOMC was raising the fed funds rate with the U.S. economy in the midst of a long expansion after the Great Recession from 2007 to 2009. The yields on long-term Treasuries—7, 10, 20, and 30 years—are at record lows, with the return on the 10-year Treasury below 1 percent at midday March 4. However, the yield curve has uninverted as the yield on the 3-month Treasury bill has moved below that on the 10-year Treasury note; this is historically the best predictor of recession.

Fed Chair Jerome Powell held a press conference the morning of March 3, after the FOMC announcement. He reiterated that U.S. economic fundamentals are “strong,” in particular citing the labor market. However, he also said that “the virus and the measures that are being taken to contain it will surely weigh on economic activity, both here and abroad, for some

FOMC CUTS RATES BY 0.5 PERCENTAGE POINT IN RARE INTERMEETING MOVE; LABOR MARKET SOLID IN FEBRUARY

time." In response to a question at the press conference, Powell stressed that the response to COVID-19 must be "multi-faceted," but that monetary policy can be effective and "provide a meaningful boost to the economy." Powell specifically noted that monetary policy can "support accommodative financial conditions," that is, help make sure that credit continues to flow.

The U.S. private sector added 183,000 jobs in February, according to a report based on data from payroll-processing firm ADP. Goods-producing industries added 11,000 jobs over the month, while service-providing industries added 172,000. Job gains in February were close to the 3-month average of 179,000 through January.

PNC expects February job growth of 140,000 when the Bureau of Labor Statistics releases the official government employment report on Friday, March 6. Private-sector employment likely rose 100,000 in February, with government employment up by 40,000, boosted by hiring for Census 2020. Even with hiring for the census, this would be below the average pace of 211,000 over the three months through January. PNC expects the unemployment rate fell slightly to 3.5 percent in February, which would match the 50-year low reached in 2019, and that average hourly earnings rose 0.4 percent over the month.

While the labor market remained in excellent shape in February, that counts for little in the face of the COVID-19 outbreak (see Chart 2). The BLS job numbers for February are based on data from employers during the week of February 10, and thus will show minimal COVID-19 impact. What will be much more telling, at least in the near term, are data on initial unemployment insurance claims, which

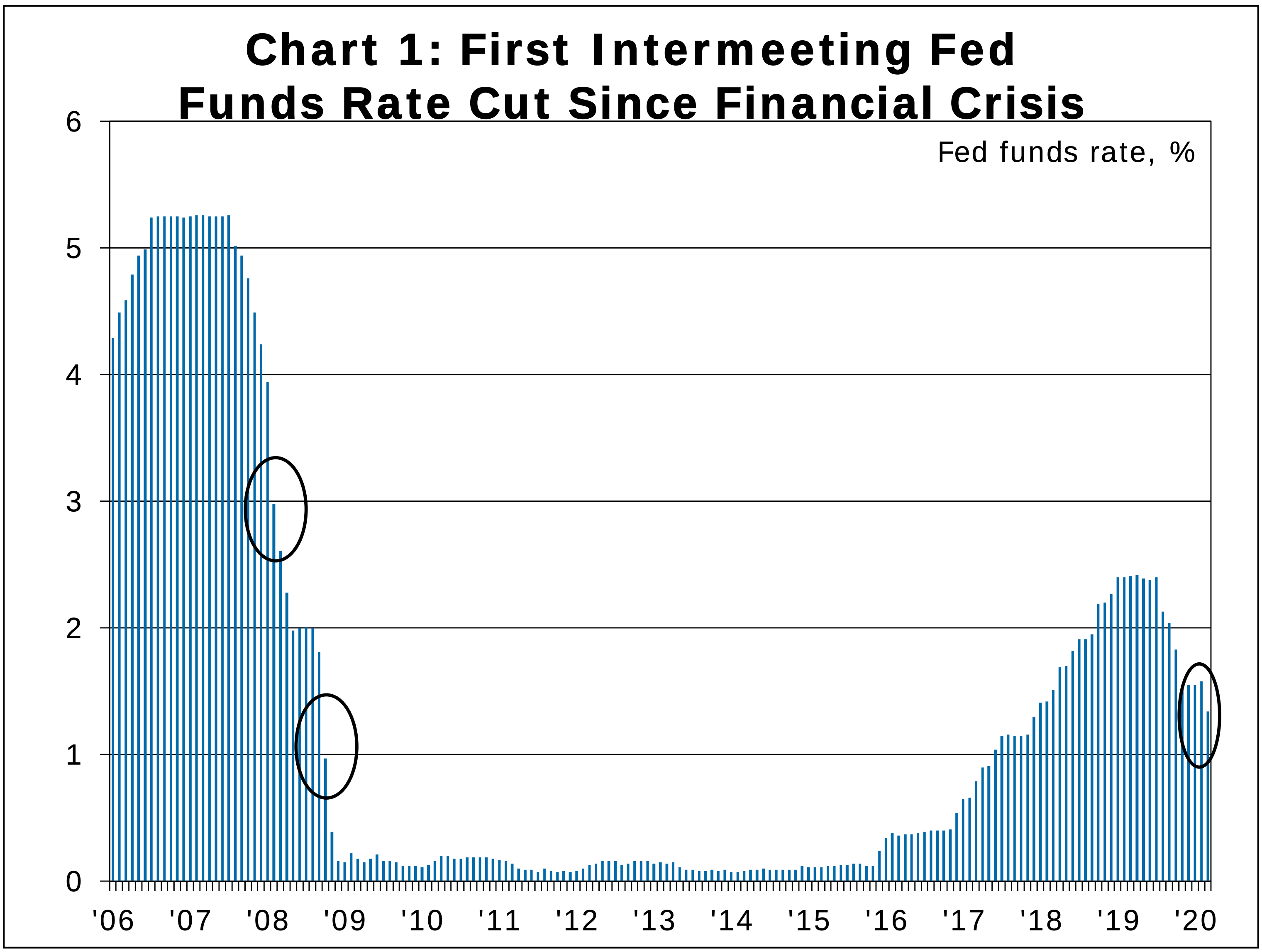

Chart source: Federal Reserve Board

FOMC CUTS RATES BY 0.5 PERCENTAGE POINT IN RARE INTERMEETING MOVE; LABOR MARKET SOLID IN FEBRUARY

are released on Thursday for the prior week, and timely surveys of consumer and business sentiment.

Although the FOMC acted aggressively in the wake of the COVID-19 outbreak, the U.S. economy is at an elevated risk of recession over the next few quarters. A U.S. recession could come from the supply side—an inability of U.S. firms to obtain inputs from abroad and/or a reduced labor supply because of restrictions on movement; the demand side—consumers stop purchasing and businesses stop investing because of movement restrictions, uncertainty, and fear; or a combination of the two. Weaker economic activity is likely to show up first in manufacturing and international travel, but could quickly spread to other industries. Those regions heavily exposed to travel, especially international travel, and high-tech manufacturing are most vulnerable in the near term.

But a U.S. recession is not inevitable. If COVID-19 does not lead to significant restrictions on movement and supply chains from abroad eventually return to normal, strong economic fundamentals and lower interest rates could allow for continued expansion, albeit with weak growth in the second quarter of this year. Housing has been strong in early 2020, and is set to further add to growth this year with mortgage rates near record lows.

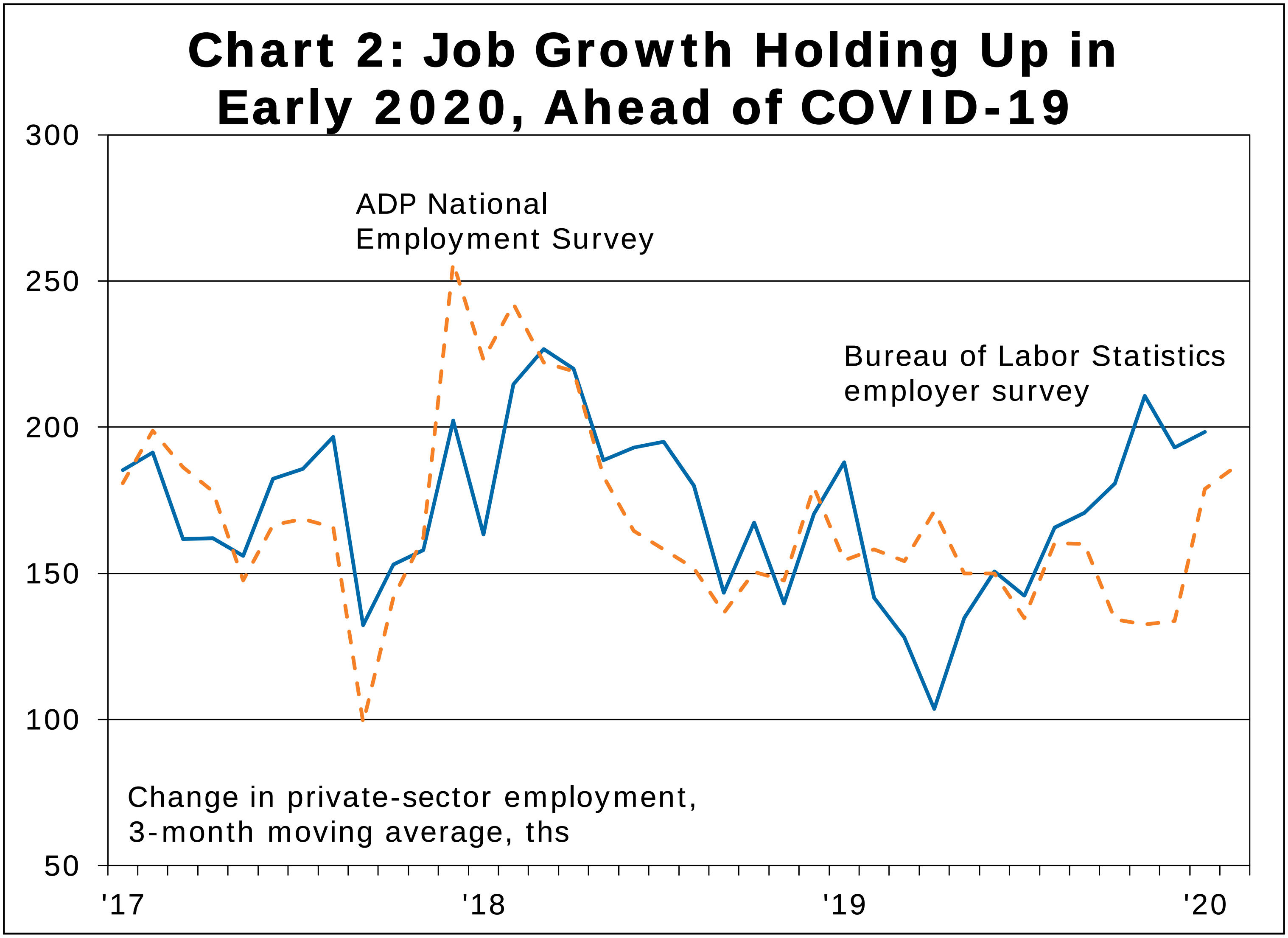

Chart sources: Bureau of Labor Statistics, ADP

Visit http://www.pnc.com/economicreports to view the full listing of economic reports published by PNC's economists.