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ECONOMIC REPORT

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POWELL SIGNALS WILLINGNESS TO CUT RATES; COVID-19 STARTING TO WEIGH ON US MANUFACTURING

SUMMARY

- On February 28 Fed Chair Powell released a statement signaling a willingness to cut interest rates in response to the COVID-19 outbreak. Financial markets expect a large fed funds rate cut over the next couple of weeks.
- The ISM manufacturing index was just barely in expansionary territory in February. U.S. manufacturing will contract in the near term because of the fallout from COVID-19.
- Personal income and consumer spending both increased in January, but backward-looking data will be of little use in determining where the U.S. economy is headed over the next couple of months. Survey-based data and weekly initial unemployment insurance claims will be of the most use.
- A U.S. recession is not inevitable, but COVID-19 makes it more likely.

Financial markets were in freefall the week of February 24 as the economic threat from COVID-19 (coronavirus) intensified. The S&P 500 plunged more than 11 percent over the week, while yields on U.S. government 10-, 20-, and 30-year Treasuries all fell to their lowest levels on record.

In response, Federal Reserve Chair Jerome Powell released a statement on February 28: "The fundamentals of the U.S. economy remain strong. However, the coronavirus poses evolving risks to economic activity. The Federal Reserve is closely monitoring developments and their implications for the economic outlook. We will use our tools and act as appropriate to support the economy." Powell's statement signals that the Federal Open Market Committee will cut the fed funds rate in the next couple of weeks. The FOMC next meets on March 17 and 18, but the Fed could act before that, perhaps by announcing an inter-meeting rate cut in coordination with other central banks. The FOMC made a number of inter-meeting cuts during the financial crisis in 2007 and 2008.

As of March 2 the fed funds futures market has priced in a 100 probability of a 0.50 percentage point cut in the fed funds rate by March 18, which would lower the rate to a range of 1.00 to 1.50 percent. The market is also pricing in additional easing over the course of 2020.

The ISM manufacturing index fell to 50.1 percent in February, just barely above the 50 level that indicates expansion in U.S. manufacturing. The index was below 50 from August through December last year, before rising to 50.9 percent in January. Of the five major components that make up the overall ISM purchasing managers' index, the production and supplier deliveries components were above 50 in February, while new orders, employment and inventories were below 50. The employment and supplier deliveries components rose over the month, while the new orders, production, and inventories components fell. There was a large 4.0 point drop in production, from 54.3 percent in January to 50.3 percent in February. The supplier deliveries index rose 4.4 points to 57.3 percent, but this actually was bad news. The ISM index interprets longer waits for supplier deliveries as a positive sign of strong manufacturing activity, since it usually implies capacity utilization is high. But in February, the longer waits were instead due to COVID-19-related delays.

Of the remaining indices, backlog of orders and new exports were above 50, while customers' inventories, prices, and imports were below 50. Four fell over the month: customers' inventories, prices, new export orders, and imports. There was a large 8.7 point drop in imports, to 42.6 percent from 51.3 percent, likely tied to supply chain disruptions from COVID-19 (see Chart 1). There was also a big 7.4 point drop in prices, to 45.9 percent from 53.3 percent.

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Of the 18 industries covered, 14 reported expansion in February, with the strongest growth in wood products, furniture, and plastics and rubber. The three industries reporting contraction were petroleum and coal, transportation equipment, and nonmetallic mineral products. Petroleum and coal was likely soft because of lower energy prices in the wake of COVID-19, while domestic transportation equipment and nonmetallic mineral products manufacturing are both heavily dependent on imports as part of their production processes.

The anecdotes collected from survey respondents mention supply chain problems because of COVID-19, and to a lesser extent Boeing's decision to temporarily halt production of the 737 MAX, as drags on manufacturing.

COVID-19 is starting to show up in the U.S. data. It is tough to pinpoint the exact impact, and much of the ISM survey was taken before COVID-19 concerns intensified in late February. But at least some of the decline in the manufacturing index in February came from COVID-19, including supply chain disruptions and lower energy prices. U.S. manufacturing activity, which had been poised to recover after contracting in the second half of 2019, is likely to decline again over the next few months because of COVID-19. The first hit will come from supply chain disruptions, with U.S. manufacturers who use foreign inputs in their production processes unable to get supplies. Depending on how bad the disruption is to U.S. consumer spending and business investment, other manufacturers could see weaker demand over the next few months. U.S. manufacturing output is likely to decline in the first half of this year, and the contraction could be severe if the COVID-19 outbreak leads to big drops in domestic spending.

Personal income rose a sharp 0.6 percent, before inflation, in January. This was the biggest gain in personal income since February 2018. After-tax income was also up 0.6 percent for the month, the biggest increase since December 2017. Labor market income rose 0.5 percent in January, with increases of more than 1 percent in dividends and transfer payments.

Consumer spending rose 0.2 percent in January before inflation. Spending on services rose 0.3 percent, while spending on durable goods rose 0.6 percent. Spending on nondurable goods fell 0.2 percent in January as energy prices declined. With income up by more than spending, the saving rate rose to 7.9 percent in January, from 7.5 percent in December.

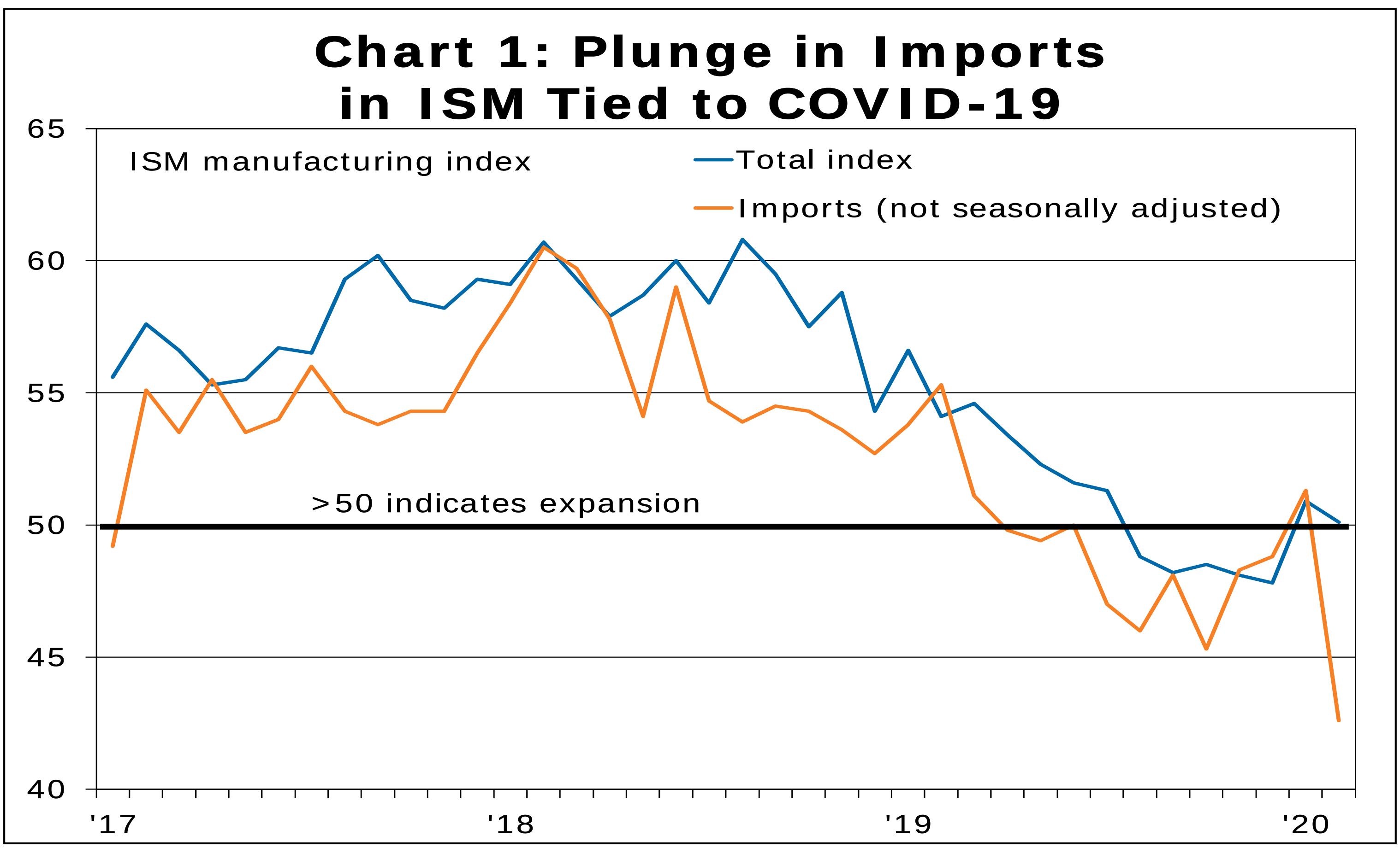

Chart source: Institute for Supply Management

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Inflation was low in January. The personal consumption expenditures price index was up just 0.1 percent over the month, as was the core index, excluding volatile food and energy prices. On a year-ago basis overall PCE inflation was 1.7 percent, up from 1.5 percent in December and 1.3 percent in the fall. Core PCE inflation was 1.6 percent in January from one year earlier, up from 1.5 percent in November and December. Although both overall and core PCE inflation rose slightly on a year-ago basis in January from December, both measures remain stuck below the Federal Reserve's 2 percent inflation objective; the PCE price index is the central bank's preferred inflation measure. With inflation set to move even lower in the near term as prices fall in the wake of COVID-19, inflation is no obstacle to additional fed funds rate cuts (see Chart 2).

Adjusted for inflation after-tax income rose 0.5 in January from December, and 2.2 percent in January from a year earlier. Real consumer spending was 0.1 percent for the month, and up 2.7 percent year-over-year.

These numbers are from January, before COVID-19 became a major story. Backward-looking data indicate that the U.S. economy was in solid shape in early 2020, but say little about the economy's trajectory over the next few months. Key data to watch in the next few weeks are survey-based measures, such as consumer confidence, and weekly unemployment insurance claims, which provide timely data on how the labor market is evolving.

Although COVID-19 will be a drag on U.S. economic growth in the near term, there is still a great deal of uncertainty about the full impact. Consumer spending makes up about two-thirds of the U.S. economy, the labor market is strong, and consumer fundamentals are solid. The saving rate is close to 8 percent, compared to 3-4 percent heading into the Great Recession, providing households a cushion. Depending on how much economic damage COVID-19 causes a recession in the U.S. is possible, but not inevitable.

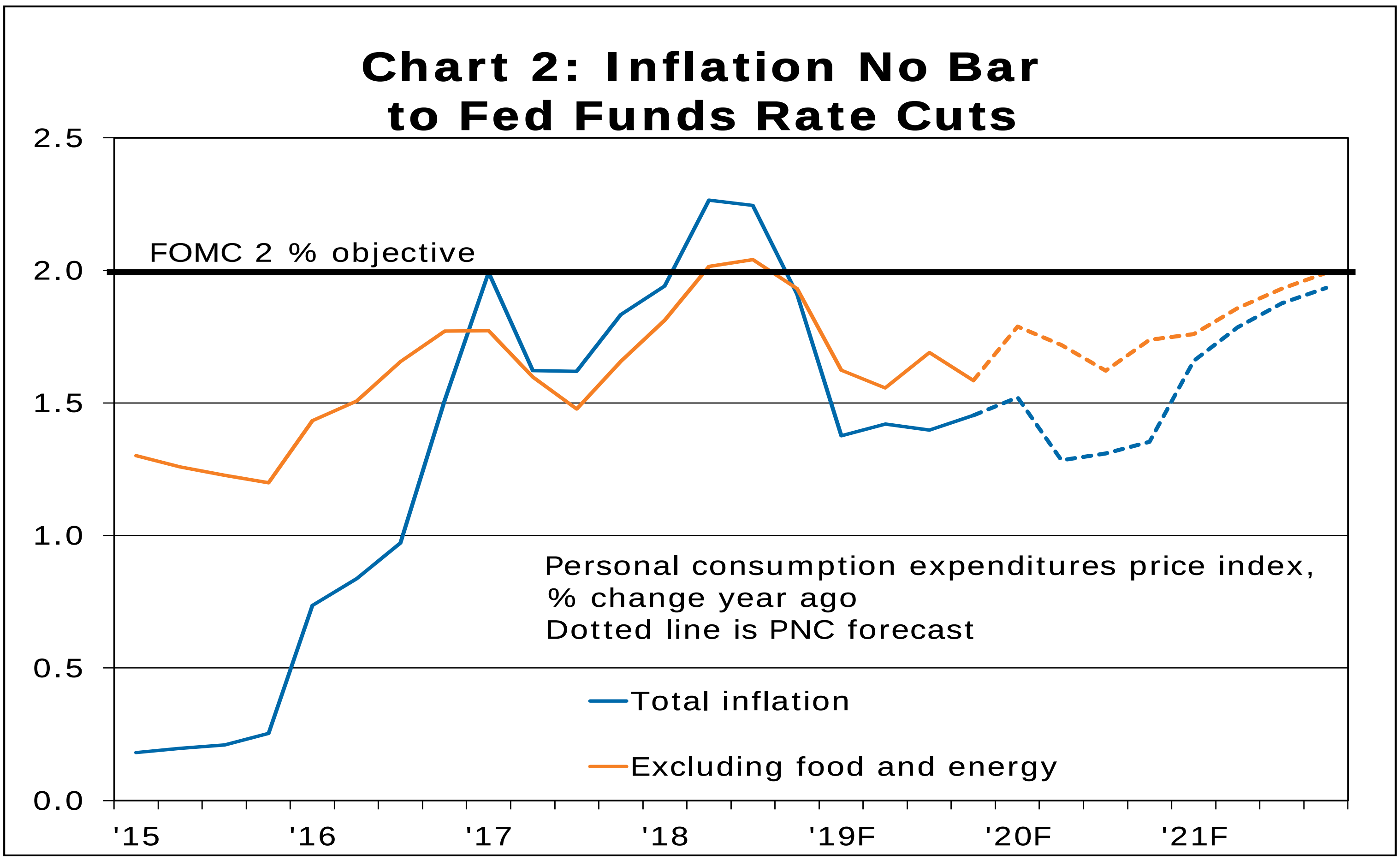

Chart sources: Bureau of Economic Analysis, PNC

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