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Economics Group

WELLS FARGO SECURITIES

Special Commentary

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Update to Our Economic Outlook

In the forecast that we released just yesterday, we called for a mild contraction in U.S. GDP in Q2-2020 with a return to growth in the following quarter. However, the events of the past 24 hours or so have made it painfully obvious that we need to rethink this forecast.

Let's start with our view about Fed policy. The Federal Open Market Committee (FOMC) is scheduled to meet on March 18. In the forecast that we released yesterday, we said that we expected the committee to cut rates 50 bps at that meeting and then a final 50 bps at its next meeting on April 29. However, financial markets have melted down in the past few days, and dark storm clouds have gathered over the economy.

We now think it is likely that the committee will slash its target range for the fed fund rate 100 bps on March 18, if not sooner. This would return the fed funds rate to the range of 0.00% to 0.25% where the FOMC maintained it from December 2008 to December 2015. Moreover, the Fed may provide some "forward guidance" by stating that it intends to keep the range at that level for an extended period of time.

Second, it seems likely that the committee will make some changes to its asset purchase program. Since August, the Fed has been reinvesting up to $20 billion per month in maturing mortgage-backed securities (MBS) that it holds in its portfolio—the Fed bought MBS in 2008-2014 as part of its quantitative easing (QE) program—back into Treasury securities. Although the yield on the 10-year Treasury security, on which most mortgage rates are based, has nosedived nearly 100 bps over the past month, most mortgage rates are more or less unchanged. At a minimum, we think that the Fed will discontinue the roll-off of MBS from its portfolio. Although we think it may be a bit premature for the committee to return to full-blown QE, we would not be surprised to see a return to asset purchases at some point if financial markets continue to plunge.

We think that any asset purchase program that the Fed may eventually announce would be targeted more toward MBS than Treasury securities. Significant purchases of government bonds by the Federal Reserve could take yields on Treasury securities into negative territory which, in our view, the FOMC is leery of doing. A downward sloping yield curve would have negative consequences for commercial banks, and bank lending could be adversely affected by such an outcome. Purchases of MBS, should it come to pass, could pull mortgage rates lower. Not only would this be supportive for re-financing activity of households, but it would help to open up credit channels more broadly.

The Fed introduced a number of lending programs during the financial crisis that were intended to return liquidity to segments of the financial markets that essentially closed down. Most financial markets are functioning today, but there are some stresses that are appearing. If needed, the Fed could eventually dust off its financial crisis playbook and re-institute some of these programs, or some variation thereof.

Finally, we need to make some changes to our economic forecast. As noted previously, we looked for a mild contraction in U.S. GDP in the second quarter with some bounce-back later this year. It looks increasingly likely that the coming contraction will be deeper and more protracted than we were anticipating just a few days ago. In short, it seems that recession is increasingly highly. The airline and hotel industries are in free fall, and there will be multiplier effects from cutbacks in those industries. Moreover, banks will likely begin to tighten credit standards—credit spreads in the corporate bond market have already widened significantly—and the uncertainty that pervades the nation at present is an awful backdrop for business fixed investment spending. Businesses may be loath to displace workers right now, but layoffs will eventually commence when order books begin to dry up. We will be sending out an updated forecast that looks for a deeper contraction in U.S. GDP, as well as updates to our foreign economic forecasts, in coming days.

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