Twelfth Federal Reserve District

FedViews

Economic Research Department
Federal Reserve Bank of San Francisco
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Sylvain Leduc, executive vice president and director of research at the Federal Reserve Bank of San Francisco, stated his views on the current economy and the outlook as of April 2, 2020.

- The human toll from the coronavirus disease (COVID-19) pandemic continues to rise around the world. As authorities implement social distancing restrictions to mitigate the spread of the coronavirus, the associated economic costs are becoming more apparent. How the economy will fare over the next several quarters remains highly uncertain, however. Much hinges on how the virus spreads and evolves over time, as well as on the effectiveness of social distancing and shelter-in-place measures. This uncertainty necessarily clouds the economic outlook.

- The uncertainty about the coronavirus is spreading through financial markets as well. The Chicago Board Options Exchange Volatility Index, or VIX, is frequently used as a measure of uncertainty based on equity market volatility. This so-called fear index measures investors' perceptions of the 30-day-ahead volatility of the S&P 500. The VIX shot up recently to a level even higher than that experienced at the height of the 2008 financial crisis. While the VIX has declined from its recent peak, it remains elevated by historical standards.

- This uncertainty has impeded the proper functioning of the financial system. Using its emergency powers, the Federal Reserve set up facilities to increase liquidity in several segments of the financial system, including money market mutual funds, the commercial paper market, and the corporate bonds markets, among others. The Fed also resumed buying Treasury securities and agency mortgage-backed securities and reduced the federal funds rate to near zero.

- Equity prices have fallen sharply since the end of February and the market has remained very volatile. Still, the passage of the Coronavirus Aid, Relief, and Economic Security (CARES) Act has helped the stock market recoup some of its losses. The $2 trillion relief package, at roughly 9% of GDP, includes several measures targeted to alleviate the adverse economic impact on households, businesses, and workers. This assistance should provide some support to the economy in the months ahead.

- Spreads on riskier assets, such as low-grade corporate bonds, have remained high. Substantially higher borrowing costs might pose challenges to highly indebted corporations. Rollover risk is somewhat limited in the near term, as only 2% of speculative-grade corporate bonds are expected to mature during the second quarter. However, corporations currently in need of funding are facing much direr financial conditions.

- The current financial conditions are also extremely challenging for small- and medium-size businesses, particularly since roughly half of them only have enough cash on hand to cover operating expenses for about one month, according to a recent JPMorgan Chase Institute report. Payroll reductions at small and medium-size businesses could have a large impact on the labor market, as these businesses account for 47% of total employment.

- With social distancing measures and shelter-in-place orders, firms have had to rapidly shed workers on an extraordinary scale. Payrolls contracted by roughly 700,000 in March and the unemployment rate rose from 3.5% to 4.4%. However, this captures only part of the worsening of labor market conditions, since the labor market surveys use the middle of the month as a reference point to compile the data. Thus, this snapshot for March occurs before most social distancing measures were widely implemented. Indeed, jobless claims surged to unprecedented levels in the last half of March, with more than 10 million workers filing new claims. Hence, the unemployment rate is likely to rise much more in the following months.

- Consumer confidence also fell in March, as economic activity in several parts of the country stalled and the economic outlook darkened. Consumer confidence is likely to decline further in the months ahead as labor market conditions worsen.

- The pandemic is also adversely affecting manufacturing activity around the world. While China's purchasing managers index (PMI) rebounded last month as the country's social distancing measures were eased, the PMIs in the United States, Japan, and the euro area fell sharply.

- The uncertainty around the evolution of the pandemic heavily clouds the outlook. As a result of the necessary social distancing measures, the contraction in economic activity will be deep in the second quarter, accompanied by a steep rise in unemployment. How the economy evolves thereafter will largely depend on the effectiveness of social distancing measures and whether the virus weakens during the summertime or experiences a second burst in the fall. It will also depend on whether social interactions quickly resume once the virus abates. Given the rareness of similar events for comparison, our understanding of these issues is too imprecise to provide clear guidance about the evolution of the economy later this year and the next.

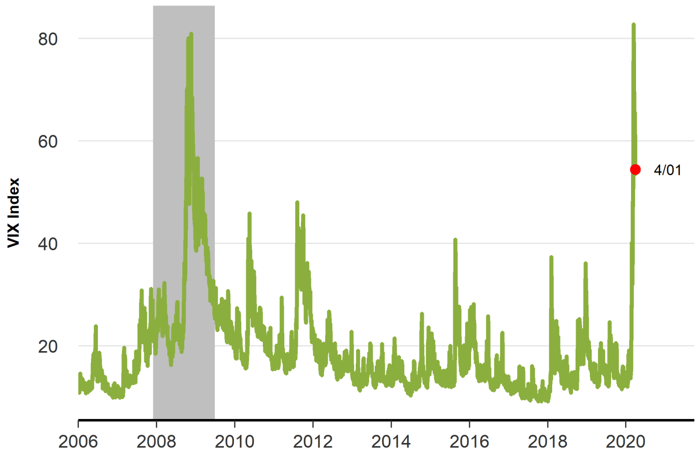
- In the best scenario, the virus is sufficiently contained by the end of the second quarter that activity can quickly resume in the second half of the year. The strength of the rebound will depend on the effectiveness of monetary policy accommodation and the fiscal relief package in providing sufficient support to households and firms to avoid typical recessionary dynamics.

- However, if the social measures last substantially longer, more firms may go out of business and more workers may remain or become unemployed, reducing aggregate demand further and lengthening the downturn. The rebound in activity would be more muted in this case, as relationships between workers, firms, and banks would need to be reestablished.

- All told, the steep decline in economic activity suggests that inflation is likely to decline this year and remain substantially below target in the near future.

Market uncertainty spiked

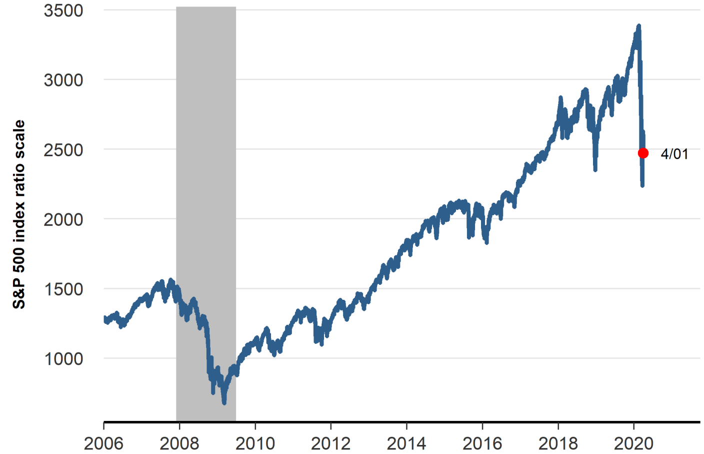
VIX



Source: CBOE

Equities recover slightly from recent low

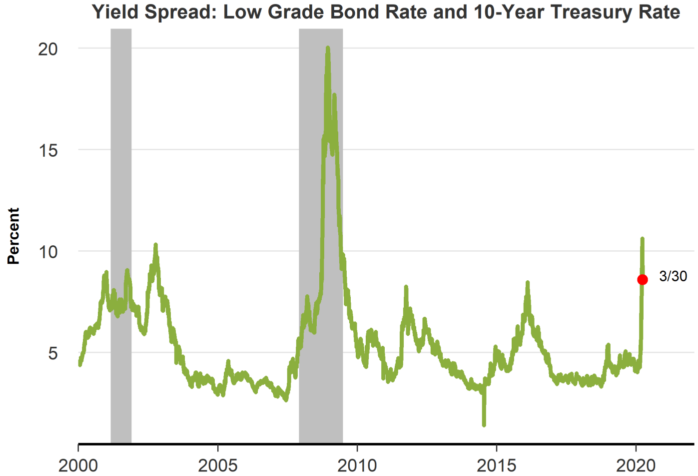
S&P 500



Source: S&P

Investors shy away from riskier bonds

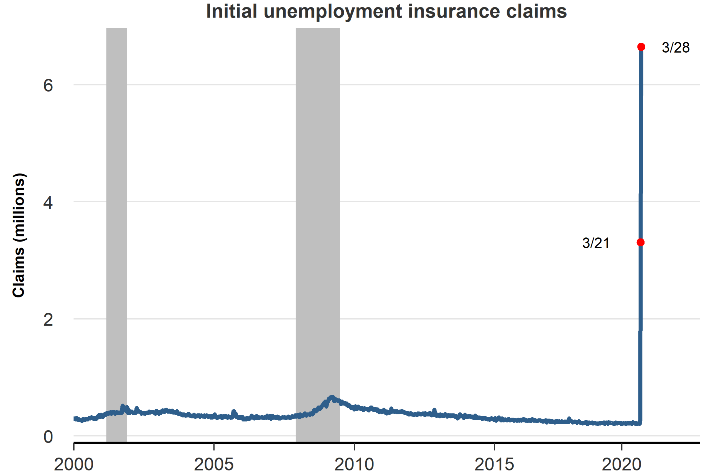
Yield Spread: Low Grade Bond Rate and 10-Year Treasury Rate



Source: FRBSF

Unprecedented rise in jobless claims

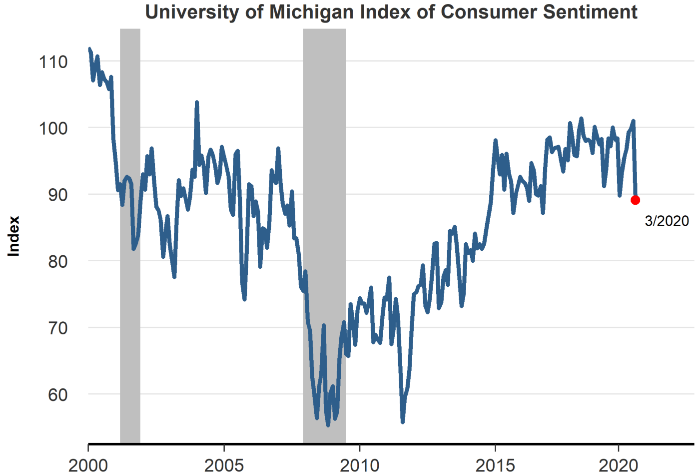
Initial unemployment insurance claims



Source: U.S. Employment and Training Administration

Consumer sentiment declines

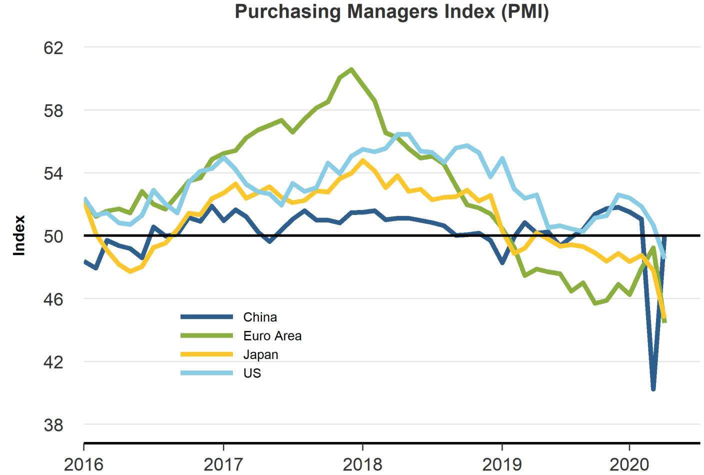
University of Michigan Index of Consumer Sentiment



Source: University of Michigan Survey of Consumers

Manufacturing activity falls further, recoups in China

Purchasing Managers Index (PMI)



Source: Haver