

The Fed prepared for more stimulus this year

- **The Coronavirus outbreak has triggered significant concerns about a more severe economic downturn worldwide**
- **It is our take that the Fed will cut rates by 50bps in a one-off move in the next meeting to be held on March 18th**
- **We do not rule out a coordinated action among G7 central banks and finance ministers, after tomorrow’s meeting**
- **However, we believe that while a strong message will be given, central banks might not act until their upcoming regular meetings**
- **This scenario also provides support to our view that Banxico will continue with its easing cycle, at least up to 6.50%**

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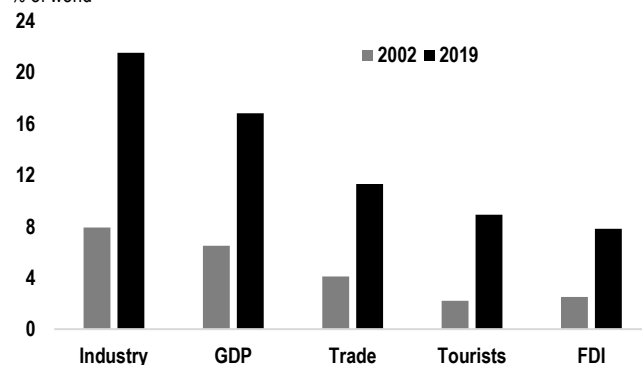
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The Coronavirus outbreak has triggered significant concerns about a more severe economic downturn worldwide. Although we are in an early stage of the [COVID-19 epidemic](#), investors are recalling the adverse economic effect of SARS in 2002/2003. Back in those years China had recently entered the World Trade Organization (December 11th, 2001), but nowadays it represents a higher share of global trade. At that moment, SARS-CoV cost nearly 1 percentage-point of Chinese GDP, with a mild effect on the world’s economy (between 15 to 20bps). Today, this headwind is more relevant, as highlighted today by the OECD inside its *2020 Economic Outlook*, with a base-case scenario portraying a 50bps effect on global growth. Beijing’s containment strategy has portrayed two clear effects: (1) A significant disruption in the global supply chain, with firms working at a low capacity; and (2) a strong shock in consumption dynamics (mainly in Asia). It is worth stressing out that the quick propagation towards other countries such as South Korea, Italy, Iran and Japan have resulted in a strong decline in tourism and other services, standing as an additional negative factor to an already weak economy in those regions. All in all, this new development has increased the debate surrounding a possible [global recession in 2021 and whether the negative consequences will be short-lived](#) (*i.e.* the arguments of a V-shaped recovery vs a L-shaped situation).

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China more integrated in the global economy

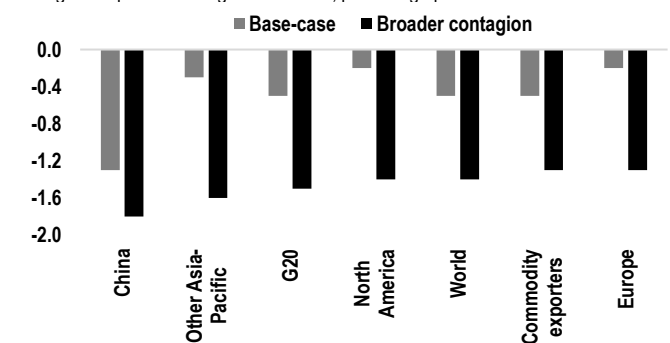
% of world



Source: OECD Economic Outlook (March 2020)

OECD's COVID-19 impact on growth

Change in expected GDP growth in 2020, percentage points

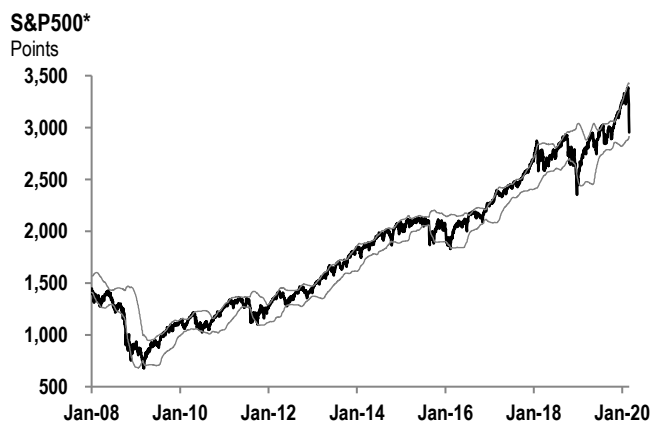


Source: OECD Economic Outlook (March 2020)

Despite COVID-19 threatening growth conditions in China and several other regions, the United States has depicted now a more resilient performance. As of today, this epidemic has resulted in a supply shock for the US economy, with minor effects on the demand side. Indeed, recent data continues to support the thesis of a full-employment economy. Nonetheless, it is still uncertain the extent of any potential adverse effect in coming months.

The Federal Reserve is likely to offset recent worrisome market conditions by easing its monetary stance by 50bps in a one-off move in the meeting on March 18th. Although established principles of monetary policy suggest that the effectiveness of central banks is undermined when accommodating supply shocks, the Federal Reserve is facing today a big dilemma given the recent market correction (*e.g.* a weekly sell-off in US equity markets not observed since the great crisis of 2008/2009) and the possibility that the current health crisis could result in a relevant decline in confidence among firms (*i.e.* affecting investment) and consumers. In the aftermath of these concerns and the quick deterioration of financial conditions in recent days, G7 MoF’s and central bankers have planed a conference call for tomorrow to achieve coordinated actions to tackle the negative economic effect of Coronavirus. We do not rule that this materializes after said meeting. Regarding the Fed, the stakes are higher after last Friday’s statement from Chairman Powell, ensuring economic agents and investors that the central bank is aware of the risks associated to COVID-19 and will use its toolset to “act as appropriate to support the economy”.

Moreover, we concur with papers released by the Bank of International Settlements in recent years, arguing that credible central banks can use their reputation (*i.e.* credibility) during supply shocks as they face a less clear tradeoff between inflation and the output gap. This situation allows them to anticipate the negative effects of supply shocks in the economy. Following all these factors, we are changing our previous call of a neutral Fed in 2020 for a new base-case scenario in which the FOMC will deliver a quick policy response by cutting its target range for the Fed funds rate by 50bps on March 18th in a one-off, preemptive move.



*Note: Grey lines mark two standard deviations calculated from the 100-day moving average
Source: Banorte, Bloomberg

Market corrections from a record close

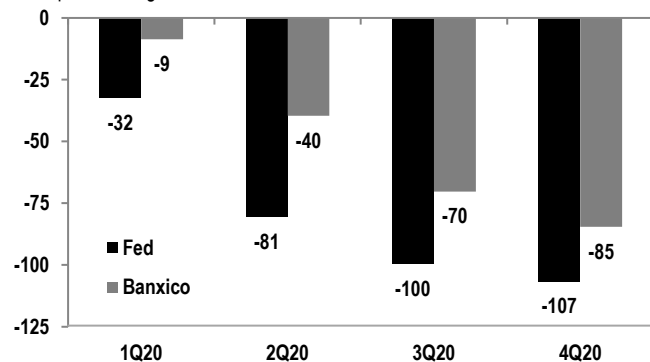
Record close	Correction date	Trading days
Nov. 3, 1919	Nov. 12, 1919	7
Nov. 28, 1928	Dec. 8, 1928	8
Jan. 26, 2018	Feb. 8, 2018	9
Feb. 12, 2020	Feb. 27, 2020	10
Sep. 23, 1955	Oct. 11, 1955	12

Source: Bloomberg Intelligence Unit

The yield curve is pricing-in additional accommodation. Like previous uncertain and highly volatile conditions, investors are ahead of the curve by anticipating additional stimulus from major central banks to counterbalance the economic and financial risks coming from the Coronavirus outbreak. In this regard, the US yield curve is pricing-in slightly more than 100bps of rate cuts for this year, with strong bets on the next two policy decisions, on March 18th and April 29th (chart below, left). This backdrop of more policy accommodation, in tandem with strong risk aversion, has resulted in Treasuries reaching new historical lows in terms of yield to maturity, especially in long-term tenors (chart below, right).

Implied rate cuts for the Federal Reserve and Banxico

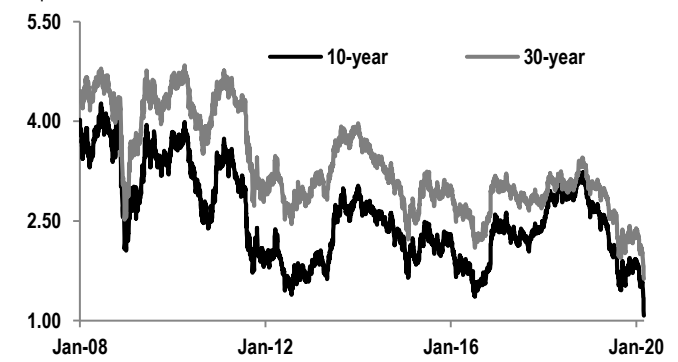
Basis points, using interest rates futures



Source: Banorte with data from Bloomberg

US Treasuries reaching new record lows

%, p.a.



Source: Bloomberg

This scenario provides support to our view that Banxico will continue with its easing cycle, at least up to 6.50%. The current backdrop represents a significant conundrum for the Mexican central bank. On one hand, the strong depreciation of the currency poses risks for CPI dynamics (*e.g.* core inflation/goods), to one of its more efficient transmission mechanisms (*i.e.* expectations), and to the perception of financial stability among economic agents. Since late 2018, the peso was outperforming other EM peers, supported mainly by appealing carry gains. However, the peso has been strongly affected in the last two weeks following negative news about COVID-19 and the risk-off mood in global markets. During this short period, the Mexican currency has depreciated against the USD in a significant fashion (5.7% from the lowest level of USD/MXN 18.54 reached on February 14th) and printing the worst performance in the EM spectrum. This could result in a more cautious stance from Banxico going forward. On the other hand, deterioration in economic conditions coming from Coronavirus and the quick policy response from the Federal Reserve and other major central banks gives Banxico's Board leeway to continue the easing cycle started in the second half of 2019. These combined forces reinforce our call for two rate cuts (25bps each) in the next two decisions on March 26th and May 14th, [bringing the reference rate to 6.50% \(our year-end call\)](#). However, we do not rule out the need for additional stimulus if needed, especially considering the current spread in short-term ex-ante real rates between the US and Mexico.

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