Financial Markets and Updated Economic Forecasts
as of 5/11/2020

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Capital Economics

Negative rates still a long shot in the US

The Fed has developed a habit of caving in the face of market pressure in recent years, but we still think the chances of it pushing the fed funds rate into negative territory are low. Fed officials have been united and consistent in arguing that the costs of negative rates are equal or greater than any benefits. More generally, global central banks appear to have cooled on the idea of negative rates. The central banks that had negative rates before the pandemic hit have not pushed their policy rates further below zero, while some Anglo-Saxon central banks have all-but ruled out the possibility.

Over the past week, the fed funds futures market has begun to price in a modest possibility of a cut in the fed funds rate into negative territory – either later this year or in the first half of 2021. Since those contracts are based on the effective fed funds rate, which has settled at 0.04% in recent weeks, well below the 0.125% mid-point of the target range, futures prices still put the implied probability of a fall to even -0.1% at well below 50%. Moreover, the 12-month Treasury yield is still well above zero. Nevertheless, this is a surprising development given how vehemently opposed the Fed has been to negative rates.

Global GDP Forecast

As a result of the coronavirus containment measures, we anticipate an unprecedented 40% annualized decline in second-quarter GDP. Even allowing for a recovery in the second half of the year, we estimate that GDP growth for this year will be -5.5%. We do expect the recovery to continue into next year, with GDP growth of 7.0% in 2021 and 3.3% in 2022. Nevertheless, even by the end of 2022, our forecasts imply that the level of real GDP will still be 2% lower than its pre-virus trend. We also anticipate some permanent scarring in the labor market, with the unemployment rate still at 5% at end-2022.

	Q1	Q2 (% q/q)	Q3	Q4	2020	Pre-virus (% y/y)	Difference (ppts)	2021 (% y/y)
US	-1.2	-12.0	5.0	5.3	-5.5	2.0	-7.5	7.0
EZ	-3.8	-20.0	12.0	5.3	-12.0	0.7	-12.7	10.0
Germany	-3.0	-11.0	6.0	2.5	-8.0	0.2	-8.2	4.5
France	-3.4	-19.0	14.8	5.5	-10.0	0.8	-10.8	7.5
Italy	-7.0	-30.0	25.0	10.0	-18.0	0.2	-18.2	15.0
Spain	-6.2	-27.2	24.5	7.3	-15.0	1.3	-16.3	10.0
Japan	-0.5	-12.0	7.2	2.5	-7.0	-0.2	-6.8	5.0
UK	-1.5	-24.0	16.0	4.8	-12.0	1.0	-13.0	10.0
Canada	-2.7	-14.0	6.7	5.7	-8.4	1.7	-10.1	7.7
Australia	-1.9	-12.0	2.8	3.3	-7.0	2.0	-9.0	8.0
Brazil	-0.5	-10.0	3.0	2.5	-5.5	1.5	-6.0	2.5
Mexico	-1.6	-12.5	7.0	2.5	-8.0	0.5	-8.5	5.0
Russia	-1.3	-12.0	6.5	3.0	-6.0	1.8	-7.8	4.5
Turkey	-3.0	-16.5	9.0	8.5	-8.3	4.3	-12.0	8.0
China (CAP)	-19.5	13.5	7.0	3.5	-5.0	5.0	-10.0	15.0
India	-2.0	-16.0	18	6.5	-4.0	5.7	-9.7	8.0
Korea	-0.5	-8.0	5.8	1.7	-3.0	2.5	-5.5	6.0
World	-5.5	-6.5	5.5	4.0	-5.7	2.8	-8.5	8.7

CAPITAL ECONOMICS

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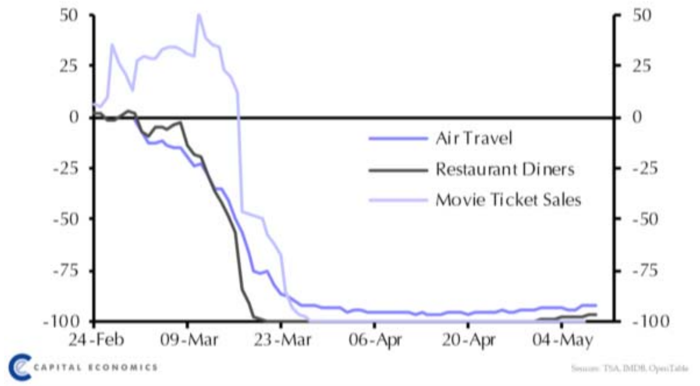
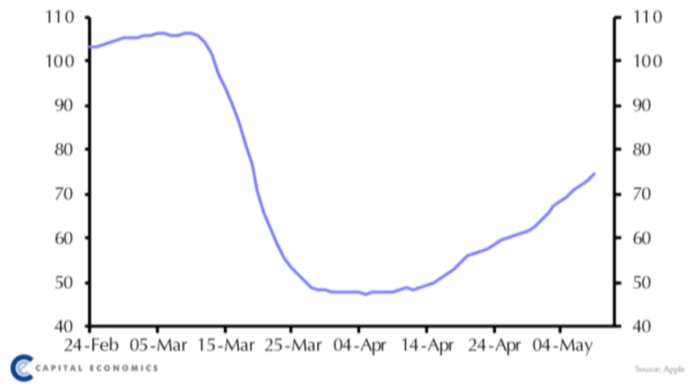
U.S. Discretionary Consumption (% Year Over Year)



Apple Maps Routing Requests (7 Day Moving Average, January-February Average = 100



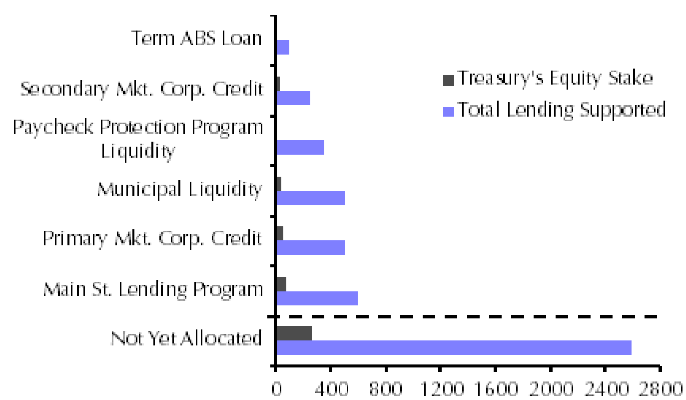
Fed Watch

Fed lending could eventually reach $4.5 trillion

The focus is now firmly on the six new facilities announced by the Fed to support the flow of credit to households and non-financial firms, with the Treasury providing the initial capital injection to indemnify against losses.

The Term ABS Loan Facility extends up to $100bn of credit in return for a variety of consumer and business loans posted as collateral. For the first time ever the Fed will also lend directly to firms, purchasing up to $750bn of corporate bonds including recently downgraded junk bonds. The Main Street lending facility extends an additional $600bn of credit to smaller firms. Finally, the Fed is working to support the SBA's Paycheck Protection Program, offering to purchase the full $350bn of business loans extended. These facilities are still being rolled out but, overall, the Fed will use $195bn of Treasury capital to extend loans worth up to $2.3trn, equivalent to 10% of GDP.

Chart 3: Fed H'hold & Business Loan Facilities ($bn)



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Source: Federal Reserve, Capital Economics

But the eventual total could be much greater. The CARES Act authorized up to $454bn in Treasury funding for the Fed's programs, with less than half that allocation now being used. Officials may be deliberately keeping some powder dry or allowing for loan losses coming in higher than expected. Nevertheless, assuming the same degree of leverage, this suggests that the Fed could eventually expand these lending facilities to more than $4.5trn. While we don't expect an expansion to be announced soon, the upshot is that the Fed's balance sheet, which has already risen to $6.2trn even before these lending programs take effect, could top $10trn before long.

Global Interest Rates (as of 10:00 am on 5/11/2020) and One Month Change

10 Year Government Rates

India	6.17%	(32 bps)
Mexico	5.94%	(118 bps)
Greece	2.13%	+38 bps
Italy	1.85%	+27 bps
South Korea	1.47%	n/a
Australia	0.95%	+5 bps
Portugal	0.92%	+2 bps
Singapore	0.85%	(21 bps)
Spain	0.79%	+1 bps
New Zealand	0.70%	(48 bps)
U.S.	0.69%	(3 bps)
Canada	0.55%	(20 bps)
Hong Kong	0.43%	No Change
U.K.	0.25%	(5 bps)
France	-0.03%	(13 bps)
Netherlands	-0.25%	(16 bps)
Germany	-0.53%	(18 bps)
Switzerland	-0.59%	(20 bps)
Japan	n/a	n/a