Fed Stays "All Hands on Deck" in the Face of Virus Uncertainty; Net-net, Mildly Market Positive

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- The outcome of the Federal Reserve's meeting on July 29, 2020 was largely as expected. Financial market functioning has been largely restored by the Fed's aggressive actions last spring, but the economy is still operating at a level well below its pre-virus pace, despite the rebound in activity since April. The Fed thus reiterated its intent to provide monetary support for as long as is needed for what is expected to be a long, drawn-out recovery.

- But Fed Chairman Powell also emphasized this is first and foremost a health crisis, and the path of the economy will depend critically on the path of the virus going forward. The Fed is watching for any potential slowdown in economic activity in the aftermath of the pickup in virus cases in June and watching for potential additional virus flare-ups going forward. And while news that a vaccine might possibly become available around year-end is a hopeful development, Powell emphasized the Fed's job right now is not to plan for upside surprises, but instead, focus on supplying the support that is currently needed.

- To this end, the Fed (with approval by the Treasury) extended its various credit and liquidity facility backstops to December 31, 2020, previously set to expire in September 2020. And the Fed's provision of US dollar liquidity to the global financial system—via swap lines with foreign central banks and a repo facility for foreign central banks' U.S. Treasury holdings—-will be extended through March 31, 2021.

- The Fed has already given guidance that the Fed funds rate is expected to remain at its current near-zero level until the economy is well on its way to achieving the Fed's inflation and employment mandates, and guidance that it will continue to purchase Treasuries and agency MBS and CMBS at least at its current pace. And while the Fed's much-anticipated Policy Framework Review, previously expected to be released around June 2020, was side-lined by the crisis, Powell provided a preview in his press conference, noting it would likely simply codify much of what the Fed is already doing.

- Both the massive monetary and fiscal support have undoubtedly contributed to the rebound in activity that began in May. Powell noted household spending has recovered about half of its previous decline, employment has regained about one-third of its losses (although unemployment as of June remains at a still-elevated 11.1%), auto sales and housing activity have picked up strongly, but business fixed investment has yet to show any recovery. Meanwhile, Powell noted, the aftermath effects on the economy of the Covid-19 crisis is expected to be fundamentally disinflationary. The Fed thus is credibly in it for the long-haul, with the Fed funds rate expected to stay at its current level for at least the next several years. The Fed will provide a formal update on its projections at its meeting this September.

Market Upshot: Near-Term Potential for Volatility; Longer term? Search for Return Supports Buoyant Markets

Despite no new measures at today's meeting, the Fed simply reiterating its steady commitment to support the economy through the crisis via current policy and whatever else is necessary to eventually return it to full employment and price stability (2% inflation in their estimation) was enough to support the current optimistic market backdrop. **This leaves our market outlook relatively unchanged: accepting that the coronavirus, politics, and other risk drivers could create intermittent market volatility; but net-net, expecting some further yield curve bull flattening and spread compression as the most likely scenario over the next six-to-12 months**.

Source(s) of data (unless otherwise noted): PGIM Fixed Income as of July 2020.

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