

The US Fed's expected to prolong the party with a cut this week

The US economy is experiencing its longest expansion on record, but weaker external demand and trade tensions are risks to the outlook. A benign inflation backdrop allows the Federal Reserve room to offer support and cut rates by 25bp next week

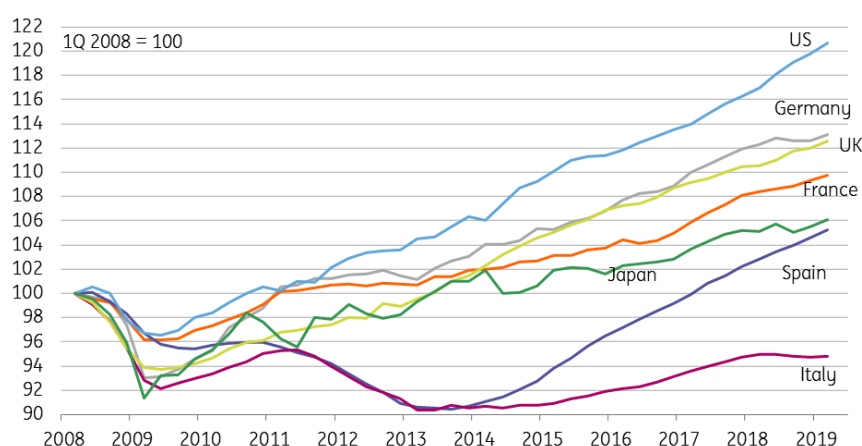


Fed Chairman, Jerome Powell (centre) with the Bank of England's Mark Carney and David Malpass (right), President of the World Bank Group

Slowdown signals

The US economy has performed solidly since the end of the financial crisis thanks to aggressive stimulus from a number of sources. The combination of a swift recapitalisation of the banking sector, interest rate cuts and quantitative easing allowed borrowing costs to fall sharply and credit to remain available. This helped to support asset prices while plunging interest rates also contributed to a weaker, more competitive dollar exchange rate. More recently, the US has experienced President Trump's tax cuts, which have helped drive the US economy to new highs. In fact, the current expansion is the longest since the National Bureau for Economic Research's data records began back in [1854](#), with the US clearly outperforming key trade partners as you can see in the chart below.

Level of real economic output versus 2008



Source: Macrobond, ING

However, a weaker global growth backdrop, as underlined by recent eurozone figures, and heightened trade tensions have started to weigh on US activity. Inventory and trade numbers have obviously been impacted, but as Fed Chair Jerome Powell noted in recent testimony, "growth in business investment seems to have slowed notably" as well.

President Trump, a vocal critic of the Federal Reserve, has demanded aggressive policy stimulus to support the US economy, but with the US consumer sector continuing to perform strongly, thanks to low unemployment and the combination of rising wages and asset prices, the Fed has been reluctant.

Prevention versus cure

That situation is now changing. After having raised interest rates in December, the language of officials has shifted significantly with Jerome Powell stating that "uncertainties around trade tensions and concerns about the strength of the global economy continue to weigh on the US economic outlook". For now, there is a tentative truce with US-China trade talks resuming. Unfortunately, the two sides remain a long way apart on key issues so we can't rule out the possibility that talks break up acrimoniously once again. Another round of tariff hikes would lead to a renewed bout of pessimism and contribute to more pronounced economic weakness by disrupting supply chains, putting up costs and hurting profit margins.

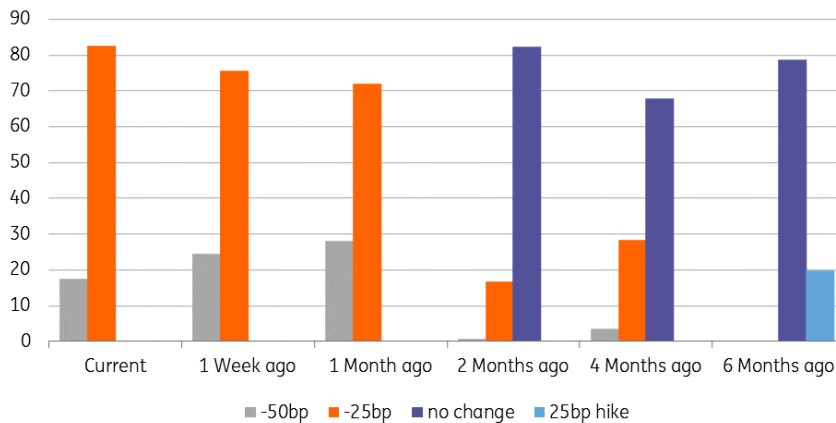
Such an environment would be negative for equity markets and make US businesses more reluctant to invest and hire new workers. Therefore it was interesting to hear Jerome Powell say in his latest testimony that "many FOMC participants saw that the case for a somewhat more accommodative monetary policy had strengthened". He too appears to be backing the case by arguing "an ounce of prevention is worth more than a pound of cure". This is a clear signal the Federal Reserve is set to ease monetary policy by cutting interest rates next week.

25bp or 50bp?

Several analysts have made the case for the Fed going early and aggressively to head off the risks to US growth with a 50bp move on 31 July. However, recent firm data has put pay to that view with the implied probability of such action drifting lower over the past couple of weeks. St Louis Fed

President James Bullard, who is perceived to be one of the most dovish members of the FOMC having voted for a rate cut in June, has also downplayed that prospect. He said last Friday that “I’d like to go 25bp at the upcoming meeting”. Moreover, we have to remember that at the June FOMC meeting, the median forecast of FOMC members had no rate cuts for this year and only one for next. The newsflow hasn’t deteriorated over the intervening period, so based on this we expect just a precautionary 25bp rate cut next Wednesday.

Implied probability of different scenarios for July 31st FOMC meeting



Source: Bloomberg, ING

Insurance action

Our view is that we are seeing merely some insurance policy easing, similar to the Fed’s response to the 1995-96 and 1998 slowdown fears, is given credence by the Fed’s assurance that “our baseline outlook is for economic growth to remain solid, labour markets to stay strong and inflation to move back up overtime” to 2%. Indeed, the recent improvement in manufacturing surveys coupled with the very strong numbers coming from the household sector suggests economic fundamentals are broadly in decent shape.

We don't believe the Fed is seriously contemplating the 100bp of rate cuts that markets are currently expecting by the end of 2020

At this stage, we don’t believe the Fed is seriously contemplating the 100bp of rate cuts that markets are currently expecting by the end of 2020. We would argue there isn’t a great deal domestic interest rate cuts can do to mitigate against external threats, such as trade wars and weaker European growth, other than perhaps limit the upside for the US dollar. After all, mortgage rates have already fallen 100bp since November and debt servicing costs are historically at very low levels while external trade only accounts for around 10% of US economic activity versus more than 20% in China and 30% in Europe.

It's all in President Trump's hands

But also like 1995-96 and 1998, we suspect the Fed will not implement just one cut. Instead, they will likely follow up with a further 25bp interest rate cut in September. After that, it is down to the big unknown of what happens with trade policy, and that is something that is very firmly in President Trump's hands.

Should tensions escalate, markets sell-off and economic weakness spreads then the Federal Reserve will respond with more stimulus given the benign inflation backdrop. However, our trade team takes the view that the fear of economic weakness for both sides will lead to China and the US finalising a deal later this year, even if it doesn't necessarily achieve all of President Trump's initial demands. After all, President Trump wants to go into next year's election with the economy in the best shape possible. A positive boost to sentiment from a trade deal would help his re-election chances and would clearly reduce the need for any additional Fed policy easing.

Author

James Knightley

Chief International Economist, US

james.knightley@ing.com

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("ING") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies)*. The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit <http://www.ing.com>.