

US Fed policy: Insurance against failure

“Mid-cycle easing” will remain the theme as the Federal Reserve delivers another 25bp interest rate cut on Wednesday. It will be justified as insurance to mitigate the trade and global headwinds facing the economy. Rising inflation and a strong consumer mean anyone expecting a more dovish message will be left disappointed



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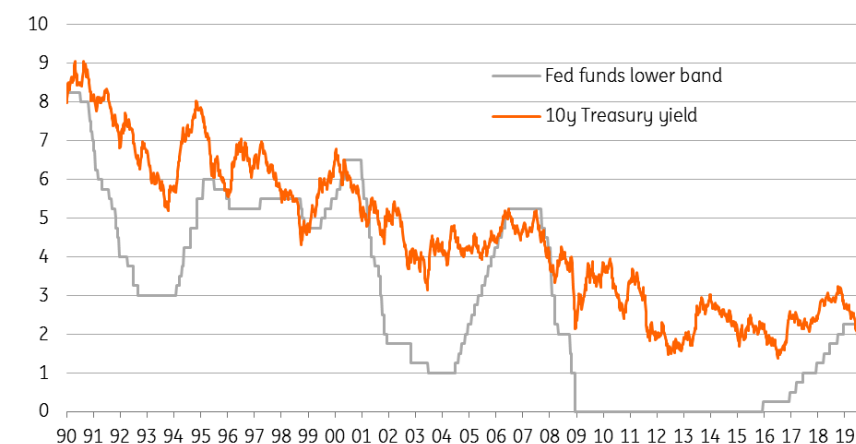
Mixed message on the economy

A lot has changed over the past twelve months. Last September futures markets were pricing in the Fed funds rate rising to 2.75-3.0% by the end of 2019. Today the pricing suggests we should be expecting a range of 1.5-1.75%, down from the current 2.0-2.25%. This swing reflects the fact that trade tensions have escalated, the global economic backdrop has weakened substantially and the dollar has continued to rise, hurting US international competitiveness. These headwinds are translating into a weaker corporate profit outlook, declining investment intentions and early signals that payrolls growth is slowing.

It is not all bad news though. While the manufacturing and internationally exposed sectors of the US economy are clearly struggling, the domestic and consumer-orientated parts are doing very well, buoyed by a strong jobs market and rising wages. There is also evidence that domestic inflation pressures are starting to build with core inflation picking up notably. So while policy easing

is the name of the game, the scale of rate cuts needed is clearly up for debate. We continue to think the market is expecting too much.

Fed funds target rate versus 10Y Treasury yield



The Fed's "mid-cycle" adjustment

July saw the first Federal Reserve interest rate cut since December 2008, which Fed Chair Jerome Powell was at pains to emphasise should not be interpreted as the start of a series of aggressive moves. Instead, it was termed a "mid cycle adjustment" and should be seen as a parallel with the three rate cuts in 1995-96 or the three in 1998 that were enough to keep the US out of recession despite headwinds to economic activity.

"we're thinking of it as essentially in the nature of a mid-cycle adjustment to policy... It's not the beginning of a long series of rate cuts... I didn't say it's just one". Jerome Powell, 31st July 2019

Internal resistance may grow

Since that July meeting, the newsflow has on balance improved marginally. While manufacturing continues to struggle, the strength in the consumer sector is clearly evident while some improvement in the US-China trade rhetoric has boosted equity market sentiment. The biggest change has been the pick-up in inflation pressures. On a three month annualized basis both average hourly earnings and core CPI are rising at their fastest rates since before the global financial crisis – the former at 4.2% and the latter at 3.4%. Both Esther George and Eric Rosengren opposed the 25bp rate cut in July and given these latest developments they will oppose policy easing this week as well. It is possible that they could be joined by one or two other FOMC members.

On balance though, we think the Fed will come down in favour of cutting rates 25bp again in what will be described as an insurance move against the headwinds facing the economy. Moreover, a

Fed rate cut will help to mitigate upward pressure on the US dollar given policy loosening seen from the likes of the ECB.

Pressure from the President

However, a 25bp will not be enough to appease President Trump who has demanded the Fed follow the ECB by cutting interest rates into negative territory. He believes that while Chinese authorities are pulling all their levers to support growth during the trade war – looser fiscal and monetary policy and a weaker yuan – the Fed is not giving him the support he needs. Despite the noise and excitement the criticism creates it won't influence the Federal Reserve policy stance. After all, if the Fed does acquiesce to the President's demands there is concern he could be incentivised to take even more aggressive trade actions that create more downside risks for the economy through supply chain disruption, higher costs and more uncertainty for business. As Jerome Powell stated at the Jackson Hole conference, "while monetary policy is a powerful tool that works to support consumer spending, business investment, and public confidence, it cannot provide a settled rulebook for international trade."

Where to next?

We will also get new forecasts from the Federal Reserve next week and we are likely to see some modest downward revisions to growth from the numbers published in June. On balance, the median forecast of Federal Reserve officials is likely to signal one additional rate cut in the current cycle, maybe in 2020, but this will matter little to markets. After all the June median forecast had no rate cuts for 2019 and by the end of Wednesday, the Fed will have conducted two 25bp cuts within three months of publishing that prediction.

In terms of our view for the path of Federal Reserve policy, trade discussions remain critical to the outlook. The next round starts in October and should we get a positive conclusion then this can remove a dark cloud hanging over the global economy, which would likely limit the need for additional policy easing. Should they fail then the gloom in manufacturing may increasingly spread through the economy necessitating a step up in the pace of easing.

We believe the result will be somewhere in the middle with discussions continuing over coming months before a mini deal is struck early in 2020, allowing President Trump to focus on his re-election campaign. Such a situation is likely to mean the headwinds to growth persist, but don't necessarily intensify. We believe a further 25bp rate cut in December along with another 25bp cut in 1Q20 would be consistent with such a scenario.

Expectations for Federal Reserve forecasts

| Variable | Median | | | |
|--------------------------------|--------|------|------|------------|
| | 2019 | 2020 | 2021 | Longer run |
| Change in real GDP (June FOMC) | 2.1 | 2.0 | 1.8 | 1.9 |
| (Expected Sep FOMC) | 1.9 | 1.9 | 1.8 | 1.9 |
| Unemployment rate (June FOMC) | 3.6 | 3.7 | 3.8 | 4.2 |
| (Expected Sep FOMC) | 3.7 | 3.8 | 3.9 | 4.2 |
| PCE inflation (June FOMC) | 1.5 | 1.9 | 2.0 | 2.0 |
| (Expected Sep FOMC) | 1.5 | 1.9 | 2.0 | 2.0 |
| Core PCE (June FOMC) | 1.8 | 1.9 | 2.0 | |
| (Expected Sep FOMC) | 1.8 | 1.9 | 2.0 | |
| Fed funds rate (June FOMC) | 2.4 | 2.1 | 2.4 | 2.5 |
| (Expected Sep FOMC) | 1.9 | 1.9 | 2.1 | 2.5 |

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