# Fed to signal cuts are coming

With trade tensions likely to escalate, this Wednesday's Fed meeting looks set to confirm market expectations - precautionary interest rate cuts are coming

Source: iStock

After hiking interest rates four times in 2018 the Federal Reserve has taken a more cautious approach to monetary policy in 2019.

Concerns about the economic implications of President Trump's willingness to use trade tariffs in disputes with other countries means that downside risks to growth are building. On Wednesday, we expect the Fed to signal precautionary rate cuts are in the offing. Markets favour a 25bp rate cut in July with three additional rate cuts over the next twelve months.

We are a little more cautious seeing two 25bp moves in the second half of 2019, given the underlying strength of the US economy and our belief that President Trump will want a trade deal signed well ahead of the presidential elections next year - see our latest forecast update for more.

## Trade tensions creating downside risks

US-China trade tensions continue to intensify and there seems little prospect of a deal later this month, as had once been hoped. China will not want to be seen as having been successfully bullied into agreeing to US demands while President Trump's view that tariffs are boosting US Treasury coffers and that the "strong" US economy can withstand near-term pain suggests he's not going to back down either. Tariff hikes seem likely.

Faced with the uncertainty of an intensifying trade dispute and the higher costs and weaker profit outlook it generates, many firms may act more cautiously. This implies a slowdown in investment and hiring, which in turn leads to lower consumer spending and the threat of an economic downturn. Recent data already suggests the economy is more vulnerable to the fallout than it was in the second half of 2018 with payrolls having softened substantially and manufacturing data looking weaker.

## Language change - "patient" dropped, "closely monitoring" is in

Since January, the Fed has signalled a willingness to be "patient" on assessing whether a change in interest rate policy was going to be required. However, Fed Chair Jerome Powell has already laid the groundwork for a shift in stance by suggesting officials were now "closely monitoring" the implications of the protracted trade negotiations for the economy.

> *We expect the Fed to drop the use of the term "patient" from the accompanying statement and use the phrase "closely monitoring"*

St Louis Fed President James Bullard - an FOMC voting member was more direct, arguing that a rate cut "may be warranted soon" to provide some insurance in case of a sharper than expected slowdown". Other Fed officials, such as Charles Evans, President of the Chicago Fed, continue to talk about the US' "solid" fundamentals, but he too acknowledged that they can adjust policy "if that's necessary".

We, therefore, expect the Fed to drop the use of the term "patient" from the accompanying statement and use the phrase "closely monitoring". We also expect to see some downward revisions to their inflation forecasts to reflect the recent benign readings. This backdrop then gives them greater scope to clearly signal an easing bias within the so-called "dot diagram" of individual FOMC members expectations for interest rates.

## ING predicted changes to FOMC median forecasts

| Variable | Median | | | |
|---|---|---|---|---|
| | 2019 | 2020 | 2021 | Longer Run |
| Change in real GDP (Mar FOMC) | 2.1 | 1.9 | 1.8 | 1.9 |
| (Expected June FOMC) | 2.0 | 1.9 | 1.8 | 1.9 |
| Unemployment Rate (Mar FOMC) | 3.7 | 3.8 | 3.9 | 4.3 |
| (Expected June FOMC) | 3.7 | 3.8 | 3.9 | 4.3 |
| PCE inflation (Mar FOMC) | 1.8 | 2.0 | 2.0 | 2.0 |
| (Expected June FOMC) | 1.8 | 2.0 | 2.0 | 2.0 |
| Core PCE inflation (Mar FOMC) | 2.0 | 2.0 | 2.0 | - |
| (Expected June FOMC) | 1.8 | 2.0 | 2.0 | - |
| Fed funds rate (Mar FOMC) | 2.4 | 2.6 | 2.6 | 2.8 |
| (Expected June FOMC) | 1.9 | 1.9 | 2.4 | 2.8 |

Source: ING, Federal Reserve

## Market pricing looks too aggressive

At the last forecast update in March, four members expected rates to be hiked 25bp this year with two looking for 50bp of hikes and 11 expecting rates to be left on hold. 10 FOMC members expected a hike of some form next year while the longer run expectations were for the Fed funds rate to settle at around 2.8%. We imagine we will see the Fed put two rate cuts in for this year with stable policy next year, thereby lowering their profile by 75bp versus March.

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Currently, markets are anticipating around 100bp of easing over the next twelve months with the first cut around 80% priced for July. We think this may be a little too aggressive and look for two 25bp moves in September and December. However, should the Fed warn of outright downside risks to growth this week we will likely need to move this forward to July and September.

## A trade deal will eventually get done...

In general, our more upbeat assessment focuses on the strong US fundamentals, the tightness in the labour market, our view that President Trump wants to get re-elected next year and a trade deal will be signed. The often-repeated suggestion that equity markets are a better barometer of his success than opinion polls means that President Trump will need to be wary that pushing too far for too long on China runs the risk of weakening his re-election campaign.

After all, lower interest rates can only do so much to support the equity market if the core problem – trade – is not dealt with and global growth is deteriorating. That is not an environment within which it will be easy to retain the Presidency.

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