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US: Powell testimony suggests softly, softly approach

Financial markets have taken Jerome Powell's testimony as a signal that the Federal Reserve is fully on board for rate cuts. However, the statement is more nuanced and hints at a more cautious approach from the Fed than is currently priced

Fed Chair, Jerome Powell

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Markets like what they hear

Today's semi-annual monetary policy testimony by Federal Reserve Chair Jerome Powell offers something for everyone. Headline writers for the newswires have chosen to focus on the line that "uncertainties around trade tensions and concerns about the strength of the global economy continue to weigh on the US economic outlook". Markets also seem to like this, responding with a bullish steepening of the yield curve (2Y yield down 6 basis points and 10Y down 2bp). Expectations of a July rate cut have also firmed with the market pricing now implying around 30bp of easing on 31 July. The dollar is softer too.

With regards to a potential imminent policy easing, Powell repeated comments that "many FOMC participants saw that the case for a somewhat more accommodative monetary policy had strengthened". He also acknowledged that "business investment seems to have slowed notably", which is attributed to “trade tensions and slower growth in the global economy”.

But there were positives...

However, the statement also offered some positives and sounded more balanced than market moves initially suggested. The line “our baseline outlook is for economic growth to remain solid, labour markets to stay strong and inflation to move back up over time” to 2%, suggests to us that any rate cuts will be precautionary and tentative. Moreover, consumer spending is described as “running at a solid pace”, thanks to a strong labour market where “job openings remain plentiful”. This doesn’t suggest that the Fed is seriously contemplating the 100bp of rate cuts that financial markets are currently expecting by the end of 2020. Moreover, there isn't a great deal domestic interest rate cuts can do to mitigate against external threats other than perhaps limit the upside for the US dollar.

Preparing for action

Overall, the tone of the testimony together with Powell's previous commentary, such as his assertion that an “ounce of precaution is worth more than a pound of cure”, suggests we should prepare for rate cuts. We agree with the market that the Fed will cut rates 25bp in July and likely follow up with a further 25bp in September. Thereafter, 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.

If US-China talks break down and a new round of tariff hikes are implemented this could lead to more economic weakness through disrupting supply chains, putting up costs and hurting profit margins. 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 that doesn’t necessarily achieve all of President Trump’s initial demands. A positive boost to sentiment from this would clearly reduce the need for additional Fed policy easing.

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