

## Fed meeting - a case of the dog that didn't bark

The latest FOMC meeting dot median for 2019 did not fall, and the projections as a whole for 2019 and 2020 did not fall by as much as expected. A July rate cut is still a possibility, but the Fed isn't screaming out that it is a probability. 50bp starter cuts don't look likely. But the bond market has rallied anyway, with a 25bp July cut more than fully priced in.



Fed Chair, Jerome Powell

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## Fed under-delivers relative to the market, but the market still rallies

There was a lot of unrealistic anticipation before this Fed meeting, mainly in terms of it laying the foundations for some aggressive easing in the months to come. As our US economist, [James Knightley put it so well](#), there was a decent change in the Fed's language last night, dropping the "cautious" text in favour of "closely monitoring", but the forecasts, in terms of the dot plot median for 2019 did not even shift down at this meeting, though they are on the cusp of doing so. On top of which, there is only one cut projected for 2020.

Contrast this with the market, which now has one 25bp cut fully priced in for July, and a further cut at that meeting 24% priced in. The Fed funds futures implied rates suggest the effective Fed funds rate will decline to 1.665% by the December meeting (it is 2.37% today, implying a fall of more than 70bp - so nearly 3 full rate hikes by the end of the year). And it predicts the trough of rates coming at 1.29%, so practically 100bp of easing from today.

To me, that looks a lot too much, and even if the Fed's path is now towards easing, I think it is going to be a lot slower than these market implied rates suggest.

## 50bp starter cut - the arguments for and against

A growing market call is for the first Fed easing to come in at 50bp, not 25bp. That would explain the July pricing. There is some historical support for this, but usually only at the beginning of an oncoming crisis. A good article on Bloomberg yesterday talked about how Former Fed Chairman, Alan Greenspan, justified this approach, arguing that at the point you realized it was time for a cut, then you also realized that your last hike was one too many, requiring any move towards accommodation to cut not just once, but twice, to remove the excess tightening from the previous meeting.

That would make more sense if the Fed was hiking every meeting at 25bp as Greenspan used to do, not maintaining its cautious stance for more than six months. It might make more sense too if the Fed funds peak were not just 2.5%, rather than 4.5% or higher as it was at the last peak. It might make more sense if the economic data was screaming out a need for easing in the face of an oncoming recession. But while the data has been, in the Fed's own words, "moderate", there are still some decent pockets of strength, and the weaknesses don't look too threatening just yet.

The wild card to all of this is, of course, the Trade War and the US president. But I can't predict that or him, irrespective of base cases that we use to anchor our forecasts. I don't think the market can predict this either. So to put it bluntly, relative to current conditions, the market has priced in way too much easing way too quickly, and at some point, something has to give.

## Market response puzzling

Markets this morning are scrambling to make the Fed no-change decision yesterday and accompanying guidance a dovish story. It is, but not relative to their expectations. 10Y yields are down nearly 7-8bp from their pre-FOMC position. 2-year yields are down even more, falling from almost 1.88% to 1.73%. There is virtually no justification for that in the face of last night's information. Indeed, it would have been less surprising to see a front end sell-off, though the back-end response was always going to be tempered by the equity market reaction.

For now, equities seem to be running with the notion that this is all a good news story. The S&P500 is up, though not a lot, and maybe it is showing understandable signs of confusion that last night's meeting was maybe not the good news story the bond market seems to think it was.

FX markets are taking their cues from the front end of the US Treasury curve, with EURUSD now up to 1.1235 as of writing. Gold rallied briefly as high as \$1362/oz, but has dropped back now, and front-month WTI oil futures are up a bit as well - possibly a USD response, though there is a lot of inventory noise to muddy this particular market.

All of these, with the possible exception of oil, look as if they are overdone given the underlying

driver of rate cut expectations. A catalyst is needed though to cause a re-think. Maybe a bounce back from last month's payrolls disappointment would do it. Recent Canadian inflation figures are also perhaps a reminder that low inflation may indeed be transitory, as the Fed has been claiming. But we will have to wait quite a few weeks for data on either to upturn the current market view.

## EU meets for a chat, and probably a nice lunch

The next few days will show us the way to the next ECB President. EU leaders will be pushing their respective candidates for a variety of posts, notably, the Head of the EU Commission, the President of the EU Council, and the one that matters most for financial markets, the President of the ECB.

Deliberations are supposed to end by Friday lunchtime, though this may be optimistic. If not, then by the weekend, the EU Commission and EU Council jobs should be stitched up, and we will have a far better idea who will be replacing Mario Draghi at the ECB in the autumn.

[One way to view this is, which job will Germany get?](#) Chancellor Merkel wants her man, Manfred Weber to get the Commission. But France's Macron doesn't, and his compromise candidate of Margrethe Vestager (of Denmark) might then get the nod. If so, Jens Weidmann (Germany) could well be in with a very good chance of getting the ECB presidency, and that could make things interesting, as he is about the most hawkish candidate there is for the job - though, in all fairness, he has recently softened his tone, perhaps in preparation for the job.

The anticipation of a Weidmann Presidency could add to EUR strength in the coming months.

## Asia - Central Bank "Super Thursday"

It's a big day for central banks today, but we may well come away from all this with no easing, like the Fed. The central banks of the Philippines and Indonesia both meet to decide policy. Both have talked a good game about possible easing, subject to the data and in BI's case, subject to the state of the current account and IDR. We are predicting an "open door" to easing from both, without either of them actually cutting rates. However, if either bank does cut, my money is on the BSP, where the external balance has been looking pretty good, with a surplus registered each month since November last year.

Taiwan's central bank also meets today, as does the Bank of Japan. Similar issues exist for both but are more extreme for the BoJ. Weak growth and low inflation face already low (Taiwan) or negative (Japan) interest rates. Some further easing from Taiwan's central bank is possible, though they seem very reluctant to move below the current 1.375% benchmark interest rate. As for the BoJ, Governor Kuroda is talking a brave game of forward guidance, monetary base expansion, outright asset purchases and more negative rates. But he must know that the BoJ's ammunition is painfully low and exceptionally weak, and he will not want to throw it away unnecessarily. Only when the JPY is a lot lower, do I think they will really consider unleashing anything other than words. And words won't do anything.

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