

Federal Reserve: A material world

No change from the Federal Reserve with a reinforced message that material change is required for them to deviate from this stance. We believe risks are skewed towards weaker growth amid a benign inflation backdrop and see the opportunity for a couple more rate cuts in early 2020



Source: Shutterstock

Federal Reserve monetary policy unchanged

After the 25bp rate cuts in July, September and October, Federal Reserve officials had indicated a preference to pause barring “material” changes in the economic outlook. With the latest data flow suggesting that there is little threat of imminent recession, equity markets hitting new highs and the Treasury yield curve having steepened there was next to no prospect of any change to policy this month. That is of course what we have got – a unanimous decision to leave the Fed funds target range at 1.5-1.75%.

The accompanying press release removes reference to "uncertainties" around the outlook, says that rates are "appropriate" with the FOMC stating that " the Committee will continue to monitor the implications of incoming information for the economic outlook, including global developments and muted inflation pressures, as it assesses the appropriate path of the target range for the federal funds rate".

Mission accomplished?

They have also provided updated forecasts which are little changed from their September projections aside from lowering their end-2019 Fed funds forecast to the current level – remember back in September they were not forecasting the October 30 rate cut. Additionally, the year-end 2019 unemployment rate forecast has been lowered to reflect the recent better numbers (see their forecasts versus September in the table below).

Federal Reserve Economic Projections

| | 2019 | 2020 | 2021 | 2022 | Longer run |
|--|------|------|------|------|------------|
| Change in real GDP (Dec Fed forecast) | 2.2 | 2.0 | 1.9 | 1.8 | 1.9 |
| Previous projection (September) | 2.2 | 2.0 | 1.9 | 1.8 | 1.9 |
| Unemployment rate (Dec Fed forecast) | 3.6 | 3.5 | 3.6 | 3.7 | 4.1 |
| Previous projection (September) | 3.7 | 3.7 | 3.8 | 3.9 | 4.2 |
| Core PCE inflation (Dec Fed forecast) | 1.6 | 1.9 | 2.0 | 2.0 | - |
| Previous projection (September) | 1.8 | 1.9 | 2.0 | 2.0 | - |
| Federal funds rate (Dec Fed forecast) | 1.6 | 1.6 | 1.9 | 2.1 | 2.5 |
| Previous projection (September) | 1.9 | 1.9 | 2.1 | 2.4 | 2.5 |

Source: Federal Reserve

It is also clear that the Fed thinks its “mid cycle adjustment” has done its job, projecting that the next move in the policy rate will be a rate hike in 2021. We, like the market, continue to have our doubts and believe that with US growth risks skewed to the downside and with inflation set to remain benign there remains a strong chance of further interest rate cuts in 1H 2020.

Headwinds to persist

While last Friday’s payrolls report painted a picture of a vibrant jobs market, other data suggest that the US economy is slowing. After all, capital expenditure has contracted in both 2Q and 3Q19 with the durable goods report hinting at a likely third consecutive fall in 4Q19. Meanwhile, the latest ISM business surveys softened again while the external environment remains weak with German industrial numbers and Asian trade data reinforcing this message. Given this situation, we suggest that the pace of jobs growth seen in November is unsustainable and that economic growth will moderate.

Trade tensions also remain a key issue. It may well have been that optimism after President Trump announced a phase 1 deal with China back in October gave a lift to recent sentiment and activity data. However, the fact we are now two months on and there has been no signed deal underline the message that trade remains a very challenging area.

President Trump has suggested he is prepared to wait until after next year’s election to conclude a deal while it remains unclear as to whether the proposed tariff hikes on US\$155bn of consumer goods imports from China will go ahead on Sunday as planned. Uncertainty over trade seems unlikely to disappear anytime soon, which leads us to conclude that trade will remain a major headwind for growth in 2020 by disrupting supply chains, hurting profitability and damaging sentiment.

ING view: more to come from the Fed

Given ongoing trade uncertainty, weak external demand and the strong dollar we are comfortable to be on the softer side of market expectations for GDP growth (1.4% versus 1.8% consensus for 2020 GDP) and bond yields (targeting 1.4% in 1H20). Political uncertainty surrounding next year's election could also see businesses taking a more cautious approach on expansion plans, with an emphasis on "wait and see".

The Fed historically prefers to maintain established policy trends through elections so as to re-affirm their impartiality, but they are likely to feel much more pressure in this election cycle. If opinion polls suggest a tight contest President Trump won't be shy to cast Jerome Powell and the Fed as the "bad guys" should growth disappoint and the Fed don't cut rates. While this in itself is unlikely to sway the Fed, any negative feedback on market sentiment could.

As such, we suggest that if the Fed do feel as though a rate cut may be required at some point they are likely to try and move sooner rather than later to try and extricate themselves from political fallout. In anycase, with inflation looking benign the Fed has the flexibility to respond to potential "material" weakness so we continue to see the potential for two 25bp rate cuts in 1H20.

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>.