US: FOMC minutes = cautious optimism

The minutes to the October 30 Federal Reserve FOMC meeting underline the recent messages that officials are happy with the current policy stance, but stand ready to do more should downside risks materialize. We think they will

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A quick recap...

As a refresh, the October 30 FOMC meeting saw the third consecutive rate 25bp rate cut from the Federal Reserve with two members, Esther George and Eric Rosengren, voting in favour of stable rates. The key change in the accompanying statement was that the Fed dropped the sentence saying that the FOMC “will continue to monitor the implications of incoming information for the economic outlook and will **act as appropriate to sustain the expansion”** (our emphasis). This was changed to say the Fed will now merely “assess the appropriate path of the target range for the federal funds rate”. This, together with the cautiously upbeat Jerome Powell press conference, was interpreted as a clear signal that the Fed wants time to take stock after a cumulative 75bp of easing in July, September and October with little prospect of another rate cut at December's FOMC meeting

Growth is ok, but there are still downside risks

Today's minutes from the meeting reinforce this message with a key comment being that "participants generally viewed the economic outlook as positive". They highlighted the firm jobs market in particular with corresponding positive consumer spending while trade tensions and geopolitical risks were perceived to have "eased somewhat".

Nonetheless, economics risks remain "tilted to the downside" and even though some risks have eased "they remain elevated" according to the minutes. They were particularly wary that there was ongoing evidence of a global slowdown and that a "weakening in the global economy could further restrain the domestic economy". In turn this meant that "the risk weakness in domestic business spending, manufacturing, and exports could give rise to slower hiring and weigh on household spending remained prominent".

There was also some caution about financial risks. According to the minutes "several participants indicated that imbalances in the corporate debt market had grown over the economic expansion and raised the concern that deteriorating credit quality could lead to sharp increases in risk spreads in corporate bond markets; these developments could amplify the effects of an adverse shock to the economy". Some participants also noted nervousness about current equity and bond market valuations.

The vote could have been closer…

In terms of the vote on the 25bp rate cut "a couple" of members who voted for the 25bp cut thought it was a "close call" decision, but "many participants" felt another cut was justifiable on the basis of "weakness in global growth and elevated uncertainty regarding trade developments". Looking ahead "most participants judged that the stance of policy… would be well calibrated to support the outlook of moderate growth… so as long as incoming information about the economy did not result in a material reassessment of the economic outlook".

A "couple of participants" wanted to go further (presumably Rosengren and George). They believed there should be an additional communications "indicating that another reduction in the federal funds rate was unlikely in the near term unless incoming information was consistent with a significant slowdown".

Our take on future Fed policy

Currently financial markets appear to be slightly doubtful of the Fed's thinking and are pricing one further 25bp rate cut by July 2020 with around a 40% chance of a second by year-end. Certainly there seems little chance of another imminent move given the Fed's "wait and see" stance, but we think they may be called into action earlier and more forcefully than even the market does.

There has been hope that a phase one trade deal with China could lift some of the gloom and offer a better backdrop for the global economy, but this is taking longer to sign than hoped – we are more than five weeks on now. Moreover, if we don't get substantial rollbacks on tariffs it is hard to see the manufacturing sector receiving much of a lift given little sign of improvement in global demand. Meanwhile, last week's US retail sales number offer further evidence of a moderation in domestic consumer demand growth. While we don't think recession is a probable scenario we are certainly sub-consensus on GDP growth, forecasting 1.4% for 2020 and with inflation set to remain subdued the Fed has the scope to ease more. We continue to see a strong chance of two 25bp rate cuts in early 2020.

Little appetite for negative rates should things turn very bad...

One other interesting aspect given President Trump mentioned he had discussed negative interest rates with Fed Chair Jerome Powell earlier in the week was the Fed seemingly ruling it out as an option. The minutes showed officials were of the view that while other countries have done it “differences between the U.S. financial system and the financial systems of those jurisdictions suggested that the foreign experience may not provide a useful guide in assessing whether negative rates would be effective in the United States”. If things were to turn really bad we suggest that the Fed is more likely to drive longer dated yields down towards zero through Quantitative Easing, which would allow government to fund broad infrastructure projects at next to no cost.

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