One—Or Maybe Two—and Done For the Fed?

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- Markets didn't like what the Fed had to say…
- ...as stocks and bonds sold off while the USD appreciated
- A quarter point cut was delivered…
- ...and the balance sheet unwinding ends tomorrow...
- ...but guidance pushed back on market pricing a series of cuts…
- ...as the statement and press conference were both less dovish…
- ...in what amounted to a neutral-hawkish sounding insurance cut
- Trump has already signalled his displeasure…
- ...but the Fed has partly redeemed itself…
- ...by limiting the security blanket on damaging trade policies

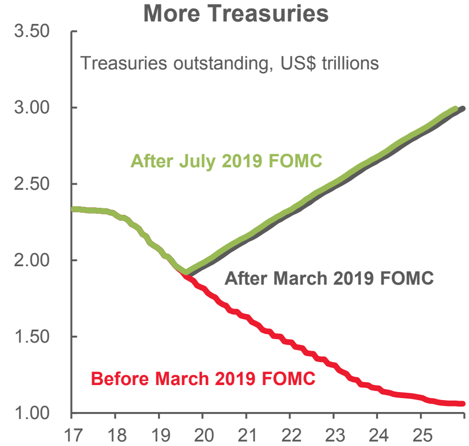
The Federal Reserve's overall suite of communications disappointed expectations by driving stocks lower to close down by over 1% across all US exchanges, bond yields higher and an appreciation in the USD. The Federal Reserve's fed funds target range was cut by 25bps to 2.0–2.25% as expected. The two year Treasury yield jumped by 15bps following the statement and press conference before closing 6bps higher post-communications. The USD is stronger against all major currencies except for pound sterling today and the USD on a DXY basis appreciated by about ½% post-communications. Fed funds futures are now pricing a little more than one additional cut over the duration of 2019. While we're not changing our forecast at this juncture, the incremental risk is geared toward the Fed easing by less than the two additional times we forecast by year-end.

While I am not sold on the notion of easing and also believe that the overall delivery of today's messages lacked some polish, I generally agree with what is a fairly deliberate attempt to push back on market pricing for Fed rate cuts. Markets and strategists were arguably going too far.

The statement was less dovish than markets anticipated in the following ways:

1. By saying the Committee "contemplates" the future path of the fed funds target rate, this implies less certainty than markets have tended to express about a series of rate cuts.
2. Instead of saying that uncertainties have "increased" the statement now says they "remain." That may be recognition of better US data, the debt ceiling and funding agreement, the avoidance of tariffs on Mexico and the avoidance of a further escalation of trade tensions with China.
3. The base case forecasts for a "sustained expansion" with "strong labor market conditions" and "inflation near" 2% remain "the most likely outcomes." There is no nod here toward greater concern about the outlook that more dovish observers might have expected.
4. There were two dissenters who preferred not to cut today including Rosengren and George. Dissension on the FOMC increased and in a more hawkish fashion.

The Fed Will Buy A Lot More Treasuries



Sources: Scotiabank Economics, FRB New York.

5. Measures of inflation compensation "remain low" instead of "have declined" which is acknowledgement that they have stabilized if not increased.
6. The conditional, data dependent language surrounding the future path of the fed funds target rate was left intact. There was no greater commitment to further easing in the statement itself.

All of this was backed up in Chair Powell's press conference, though I have to admit I've seen much finer performances. Nevertheless, Chair Powell had multiple chances to correct the impression that the statement was less dovish than expected but instead reinforced such an impression.

Powell explained that the reasons for easing today included: a) downside risks that are mostly external including in the EU and China; b) trade policy developments that at times have been disruptive; c) below target inflation with a desire to return it to target faster; d) a lower neutral rate; and e) a lower natural unemployment rate with modest real wage gains.

Powell nevertheless delivered arguments that strongly suggest the Fed is not presently inclined to ease as much as markets may desire. He did so in the following ways.

- By stating that today's cut is a **"mid-cycle adjustment"** and not the start of an easing cycle.
- By stating that **"we're not seeing a need to cut the fed funds rate a lot. We're seeing a need to adopt a more accommodative stance over time. It's not a long cutting cycle."**
- by stating that there is an opening for a **"somewhat"** more accommodative stance. "Somewhat" is less dovish than invoking expectations for a series of moves.
- When asked whether today's message is that with one or two more cuts you'll be done, Powell said **"it depends upon the data.** It's appropriate to move to a somewhat more accommodative stance now." That's not what markets wanted to hear.
- **by referencing how it's not -25bps that counts** in response to a question about limited efficacy of a modest cut and its ability to raise inflation, but the shift from a hiking bias to a small cut that has entailed greater easing this year than just the quarter point reduction. That comment raised the bar for several future reductions and suggests the Fed may think it has already done enough or is close to having done so.
- When asked if there are any circumstances under which only this one cut might be delivered, Powell passed on the opportunity to reject the option and simply said that it will depend upon incoming data and evolving risks. That's a clear signal they are not easing in an attempt to strongly overshoot the 2% inflation target and prove symmetry. If they were, he'd have teed up more cuts. He did say he is not saying they will only cut once, but also conditioned future moves on data and developments while being noncommittal.
- by even broaching the topic of what he described as **an unlikely but possible future mid-cycle hike** when that should have been taboo. He did this in response to a question about future flexibility into a possible future downturn and noted that today's fed funds rate is not necessarily the starting point for future flexibility of the Fed hikes again in future;
- **by basically saying they're ending B/S unwinding because it's just simpler and more efficient to do so now.** He did not position it as a material easing bias. Markets perhaps didn't like that but Powell's right on that count. I'm still unsure what the FOMC thought it could achieve by ending B/S unwinding just two months ahead of schedule. The accompanying chart shows the impact of expediting plans to end balance sheet run-off by two months; you'll need a microscope to detect the difference between the new line for the July FOMC meeting change versus the prior trajectory for the post-March FOMC changes as applied to the five year outlook for Treasury holdings within the SOMA.

In terms of forecast risks, we may have overshot easing expectations with three forecast cuts including today's this year. What I heard today is a Fed chair who might be done or might have one more up his sleeve. We're all data dependent, but the main takeaway is that **they are not aggressively easing with a focus upon deliberately and materially overshooting 2% to prove inflation target symmetry.** That's huge. Hugely less dovish than the more dovish voices expected or wanted to hear.

When probed about stability issues, Powell didn't seem fussed. He described financial stability risks as moderate and note a shift in business loans to stably funded off balance sheet vehicles to help address leverage.

Shortly after the communications, **President Trump predictably tweeted** "As usual, Powell let us down….We are winning anyway, but I am certainly not getting much help from the Federal Reserve!" And on that, I offer kudos to the Federal Reserve. Maybe the US administration will begin to deliver more responsible trade policy goals absent a bigger security blanket. Or not.

Please see the accompanying statement comparison. The next FOMC statement, press conference and revised forecasts including a fresh dot plot arrive on September 18th. Enjoy August!

RELEASE DATE: JULY 31, 2019

Information received since the Federal Open Market Committee met in June indicates that the labor market remains strong and that economic activity has been rising at a moderate rate. Job gains have been solid, on average, in recent months, and the unemployment rate has remained low. Although growth of household spending ***has*** picked up from earlier in the year, growth of business fixed investment ***has*** been soft. On a 12-month basis, overall inflation and inflation for items other than food and energy are running below 2 percent. Market-based measures of inflation compensation ***remain low***; survey-based measures of longer-term inflation expectations are little changed.

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. In ***light of the implications of global developments for the economic outlook as well as muted inflation pressures***, the Committee decided to ***lower*** the target range for the federal funds rate to 2 to 2-1/4 percent. ***This action supports the Committee's view that*** sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective are the most likely outcomes, but uncertainties about this outlook ***remain***. As the Committee ***contemplates the future path of the target range for the federal funds rate, it will continue*** to monitor the implications of incoming information for the economic outlook and will act as appropriate to sustain the expansion, with a strong labor market and inflation near its symmetric 2 percent objective.

In determining the timing and size of future adjustments to the target range for the federal funds rate, the Committee will assess realized and expected economic conditions relative to its maximum employment objective and its symmetric 2 percent inflation objective. This assessment will take into account a wide range of information, including measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial and international developments.

The Committee will conclude the reduction of its aggregate securities holdings in the System Open Market Account in August, two months earlier than previously indicated.

Voting for the monetary policy action were Jerome H. Powell, Chair; John C. Williams, Vice Chair; Michelle W. Bowman; Lael Brainard; James Bullard; Richard H. Clarida; Charles L. Evans; and Randal K. Quarles. ***Voting against the action were Esther L. George and Eric S. Rosengren, who preferred at this meeting to maintain the target range for the federal funds rate at 2-1/4 to 2-1/2 percent.***

RELEASE DATE: JUNE 19, 2019

Information received since the Federal Open Market Committee met in May indicates that the labor market remains strong and that economic activity is rising at a moderate rate. Job gains have been solid, on average, in recent months, and the unemployment rate has remained low. Although growth of household spending ***appears to have*** picked up from earlier in the year, indicators of business fixed investment ***have*** been soft. On a 12-month basis, overall inflation and inflation for items other than food and energy are running below 2 percent. Market-based measures of inflation compensation ***have declined***; survey-based measures of longer-term inflation expectations are little changed.

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. In support of these goals, the Committee decided to maintain the target range for the federal funds rate at 2-1/4 to 2-1/2 percent. The Committee continues to view sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective as the most likely outcomes, ***but uncertainties about this outlook have increased.*** In light of these uncertainties and muted inflation pressures, ***the Committee will closely monitor*** the implications of incoming information for the economic outlook and will act as appropriate to sustain the expansion, with a strong labor market and inflation near its symmetric 2 percent objective.

In determining the timing and size of future adjustments to the target range for the federal funds rate, the Committee will assess realized and expected economic conditions relative to its maximum employment objective and its symmetric 2 percent inflation objective. This assessment will take into account a wide range of information, including measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial and international developments.

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