Fed Digs In With Hawkish Cut

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- Fed cuts 25bps with overall communications as we expected…
- …but guides that it may be done cutting before hiking in 2021
- Even the most dovish FOMC members see only one more cut
- IOER and RPP rate spreads to target range cut by 5bps
- Fed is content with NY Fed's repo operations…
- …with more to come tomorrow morning
- A return to organic balance sheet expansion could come before year-end…
- …as the next 'six weeks' will inform this issue
- Macro forecasts were left intact
- Statement language was very little changed
- Three voting dissenters

The overall suite of Fed communications delivered a hawkish rate cut and pushed back upon aggressive market pricing for further easing. Markets reacted by pushing the two year Treasury yield up by 9bps following all communications but primarily before the press conference. The ten year yield increased by 4bps. The USD mildly appreciated against a variety of crosses. Fed funds futures contracts continue to price a couple more rate cuts by the end of 2020 but the usual cautions apply when it comes to interpreting futures contracts as pure policy rate expectations. Overall, markets took it more hawkishly but the Fed is driven by the fact that the narrative and forecasts have been going their way of late in terms of growth and dual mandate variables.

The overall suite of communications was hawkish relative to what markets had priced for reasons explained below. The net implications to our forecasts are that a) we may see balance sheet policies shifting toward organic growth sooner than previously expected and potentially as soon as October 30th or December 11th, and b) that we may not get our projected rate cut at the December meeting.

1. Dot plot signals they may be done

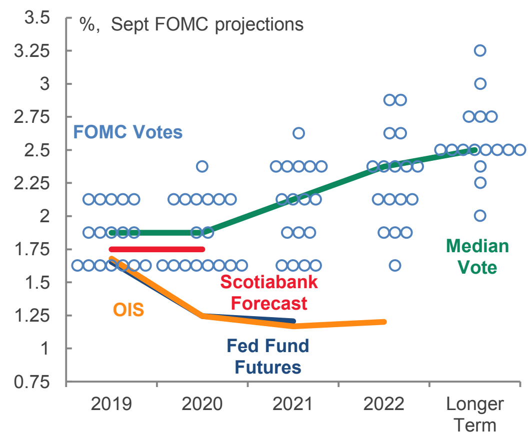
The median projection for the fed funds target rate that is contained within the 'dot plot' forecasts no further policy rate changes. The only changes involved revising down the starting point to reflect the July and September rate cuts, after which the policy rate range is projected to remain in the present 1.75%–2.0% zone next year before a quarter point hike is projected in 2021 followed by another hike in 2022 toward an unchanged longer run neutral rate of 2.5%.

The dispersion of the dots is also unambiguously more hawkish than priced into the rates complex. That's because while the median projection sees no further easing before a hike in 2021, even the most dovish dots foresee only one more cut this year and then nothing thereafter (see chart). Fed funds futures and OIS markets are significantly more bullish toward rate cuts than Fed guidance.

2. None of the macro forecast changes were material

GDP: Growth was revised up a tick to 2.2% in 2019, flat in 2020, up a tick in 2021, and adding 2022 sees growth toward long-run potential at 1.8% with the longer run forecast unchanged at 1.9%.

FOMC Federal Funds Target Rates



Note: OIS & Fed Fund Futures as of Sept 18th, 2019
Sources: Scotiabank Economics, Federal Reserve.

Inflation: All inflation forecasts were unchanged. PCE inflation is forecast to be 1.5% this year, 1.9% next year, 2.0% in 2021 and still on target at 2.0% in 2022. Core PCE inflation is still forecast at 1.8% in 2019, 1.9% next year, 2.0% in 2021 and 2% in 2022. Core PCE inflation has been going the Fed's way with a slight rise since May's 1.46% y/y trough to 1.58% in July and expectations that the September 27th update for August will follow already released core CPI higher.

Unemployment rate: The unemployment rate forecast was revised up a tick to 3.7% in 2019 and then left unchanged at 3.7%, 3.8%, 3.9% and 4.2% over 2020–2022 and the longer run respectively.

3. Statement language was little changed.

Please see the accompanying statement comparison on the following page.

a) Current conditions: The opening paragraph was left largely unchanged with one minor positive tweak offsetting a minor negative tweak. The labor market is still "strong", economic activity is rising at a "moderate" rate, and job gains are "solid". The one positive change involves reference to household spending as "strong" instead of the prior reference to having "picked up" while investment and exports have "weakened" instead of have "been soft." Inflation is described in unchanged fashion.

b) Base case outlook: Left unchanged is guidance that a "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."

c) Rate guidance: Also left unchanged is conditional guidance surrounding the policy rate that is rooted in progress toward achieving dual mandate goals.

4. Balance sheet changes are deferred

There was no change in balance sheet policy other than to signal that the return to organic growth might occur earlier than previously expected. Powell nevertheless guided that moving through how markets adjust to quarter-end funding pressures and information revealed over the next six weeks will inform such potential steps. This is not QE4 versus improving market infrastructure. In the meantime, there was no further reference to other policy discussions such as a standing repo facility.

5. Open market repo operations were sufficient

Chair Powell reinforced that the intervention by the New York Federal Reserve in repo markets worked and such tools will be relied upon "for the foreseeable future". The NY Fed then announced there will be more tomorrow (here). That did not signal a greater degree of concern toward the ability to control short-term market rates. There was no further mention of a standing repo facility but that doesn't mean it won't resurface at a subsequent meeting. What Powell said further to that was not unexpected in that it remains the Fed's goal to have in place proper market infrastructure so as not to permanently rely upon repo market interventions and this is the part that will be informed by developments over "the next six weeks." He also dismissed the short-term rates volatility as "having no implications for the economy or the stance of monetary policy." Some of the market movements into the Fed communications that rallied the rates complex could have been influenced by unreasonable expectations that the Fed would signal much greater concern and shift to QE or more aggressive cuts. That was unlikely, partly because of the weak case for doing so, and partly because the meeting process including the development of the staff's 'green book' forecasts, the Board staff's 'blue book' policy suggestions and the FOMC members' own forecast submissions generally pre-dated this week's market developments. The Fed doesn't typically change that quickly in response to such developments nor should it have done so.

6. IOER and RPP Rate cuts

The Interest on Excess Reserves rate (IOER) was reduced by 5bps more than the fed funds target range to widen the negative spread to the upper bound of the fed funds target range to 20bps. The rate on the overnight repo facility (RPP) was also cut by 5bps more than the target range to 5bps beneath the target range. These tools are designed toward strengthening the function of short-term rates markets in complementary fashion to the NY Fed's repo market operations over the past couple of days. Powell also said the Fed was not surprised by the market moves around the well understood settlement of bond auctions and payment of corporate taxes that induced liquidity issues, but that the magnitude of the effect this time was greater than anticipated and properly addressed.

7. Powell doused negative rate talk again

In response to a question in the press conference, Powell rejected using negative policy rates as a tool if their base case projections turn out to be disappointed in future. He said that in the crisis the Fed used asset purchases and aggressive forward rate guidance and they would likely rely upon the same tools if needed but with the need not foreseen at this point.

8. There were three dissenters

This wasn't a surprise as the two (Rosengren and George) who objected to cutting previously remained in opposition and were joined as dissenters by Bullard for the very different reason that he would have preferred a half point reduction today. Of note is that even Bullard's dissenting vote is backed by limited appetite for further easing in the near-term versus preferring to get it done and out of the way in one 50bps swoop today.

RELEASE DATE: SEPTEMBER 18, 2019

Information received since the Federal Open Market Committee met in July 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 household spending ***has been rising at a strong pace***, ***business fixed investment and exports have weakened.*** 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 1-3/4 to 2 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.

Voting for the monetary policy action were Jerome H. Powell, Chair, John C. Williams, Vice Chair; Michelle W. Bowman; Lael Brainard; Richard H. Clarida; Charles L. Evans; and Randal K. Quarles. **Voting against the action were James Bullard,** who preferred at this meeting to lower the target range for the federal funds rate to 1-1/2 to 1-3/4 percent; and Esther L. George and Eric S. Rosengren, who preferred to maintain the target range at 2 percent to 2-1/4 percent.

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.

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