

Fed Preview: A Hawkish Cut?

- Three reasons to expect another rate cut this week
- Six reasons why it is likely premature to strongly signal the end of rate cuts
- The risk of statement changes is slanted toward being more dovish...
- ...which would be at odds with signalling cuts are over
- More short-term funding market tools?
- Powell's press conference should add to balance sheet guidance

The FOMC meeting culminates in a statement on Wednesday at 2pmET followed by Chair Powell's press conference at 2:30pmET. No forecasts will be issued this time after the economic projections including the 'dot plot' were updated at the September 18th meeting. Another 25bps rate cut is expected but the largest potential risk surrounds the debate over whether it may be a hawkish cut on the future guidance. Personally I'm not convinced.

Another –25bps cut to Fed funds

The target range is forecast to be reduced by 25bps to 1.5%–1.75% while the Interest on Excess Reserves rate will drop by 25bps to 1.55% and remain at an unchanged spread of -20bps to the upper end of the fed funds target range.

The consensus of economists is somewhat divided on the call. Bloomberg's consensus shows nearly 80% of economists expecting a 25bps cut and the remaining one-fifth a hold. The hold camp has some cover in the last dot plot that forecast no further easing. Fed funds futures and OIS markets are pricing 90% odds of a cut.

Why are we in the cut camp? For one, it would be imprudent for the Fed to surprise markets in the present environment. Second, the path since the last meeting in mid-September has witnessed increased evidence of a synchronous deterioration in global growth prospects and continued uncertainty toward Brexit and trade policy developments with as yet nothing resolved. This has kept the New York Fed's recession probability at just over one-in-three odds over the coming year. Third, the Fed could be accused of putting policy tools at loggerheads to one another if it surprised markets with a hold while it was still addressing dysfunction in short-term funding markets.

Guidance: Hawkish or Open-ended?

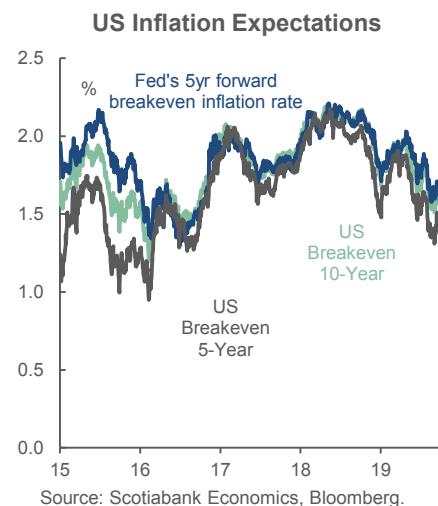
A noncommittal policy bias is likely to be retained. The statement is likely to repeat that the committee will "act as appropriate" in data-dependent fashion regarding dual mandate progress. The press conference is likely to reaffirm that policy is not on a preset path and that the economy is in a good place.

Some argue that the Fed might instead choose to signal a bit more patience this time even if it doesn't reintroduce the term itself to the statement. This would be in

CONTACTS

Derek Holt, VP & Head of Capital Markets Economics
416.863.7707
Scotiabank Economics
derek.holt@scotiabank.com

Chart 1



keeping with Powell's reference to a mid-cycle adjustment at the July FOMC press conference which signaled a handful of cuts at best versus a larger series of moves.

At the extreme, some think the Fed may more directly indicate that further easing is off the table. Removing or weakening "act as appropriate" would be one such step in addition to press conference signals.

There are several arguments against this possibility:

a) When Powell referenced "mid-cycle adjustment" in July, he did so before evidence of a deteriorating global economy subsequently increased and trade policy developments soured. It's too early to tell if a détente in US-China trade relations is unfolding or if this is another false promise built upon small steps, innuendo or downright lies. Further, recall that Treasuries abruptly sold off when he issued those words and **Powell has not repeated them since July 31st.** In fact, only Chicago Fed President Charles Evans repeated "mid-cycle" and that was about one month ago.

b) Top of the house Fed officials have continued to reference "as appropriate" language including Vice Chair Clarida on October 18th, and Chair Powell's speech on October 8th ([here](#)) that was likely titled "Data-Dependent Monetary Policy in an Evolving Economy" for a reason. In other words, if you communicate you are done, then how do you square that with still being data-dependent? **I'm not sure the Fed is of the mindset to do a 180 on such guidance within the span of a few short weeks versus priming markets a bit better in future.**

c) Fed funds futures markets have two cuts priced by next summer including this week's expected cut. It's debatable that markets will believe a shift toward more hawkish Fed guidance especially after the dot plot indicated last month that there would be no easing ahead of this week's expected cut. Regardless, this is a chicken-and-egg game that risks having an adverse effect upon the bond market. **If the Fed wishes to move toward signalling the end of the cutting cycle then it likely has more work to do ahead of subsequent decisions in order to avoid unduly shocking markets.**

d) **In the current state of funding market pressures, heaping additional stress may be very poorly timed and at loggerheads with other efforts to heal funding strains.** There remains high uncertainty regarding future potential bouts of funding pressures that would not be well served by dislocation effects stemming from a shift in market expectations toward future Fed policy actions.

e) There are **too many unknowns** in a deteriorating global economy to pre-commit to a particular course of action especially given sensitivities surrounding the Fed's policy reversals this year. Conditional "as appropriate" language keeps the door open to more if needed but doesn't commit to it.

f) **If the Fed wishes to prove that its 2% inflation target is symmetrical and wants to raise inflation expectations, then it's nowhere close to achieving this.** Core PCE inflation stood at 1.8% y/y in August ahead of this Friday's update. Market-based measures of inflation expectations remain low (chart 1). Engineering a policy overshoot as part of a strategic review is nowhere close to being achieved.

In short, while I still think that Fed easing emboldens Trump's protectionist policies in a negative feedback loop between trade and the rates complex and that downward

Chart 2

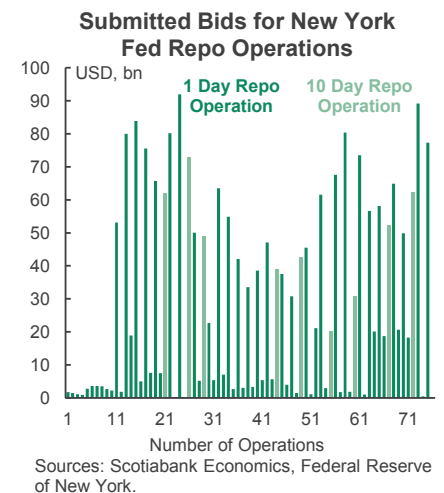


Chart 3

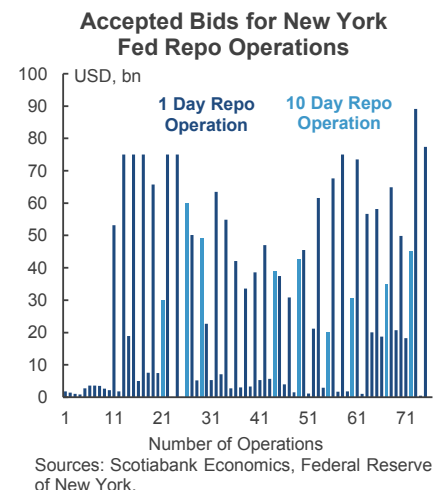
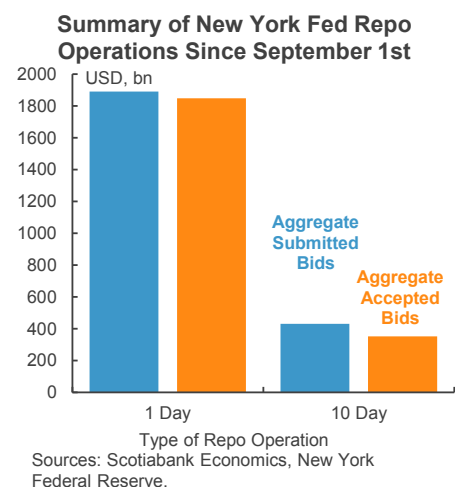


Chart 4



pressures upon inflation earlier in the year were transitory, forecasting what the Fed will *actually* do leaves one unconvinced that they will go out of their way to say they are done this week. The economy is in a good place that could result in future powder being kept dry, but potentially greater risk lies ahead and the Fed believes more strongly it should front-load easing this time around. A compromise could be a more subtle indication that the criteria for further easing is getting a bit tougher to meet, rather than harsher measures such as removing ‘as appropriate’.

Statement language—Unchanged, but turning more dovish would conflict with signalling the end

The description of current conditions in the opening paragraph is likely to be left intact or little changed. It remains fair to describe job gains as “solid”, the unemployment rate as “low”, and consumption growth offsetting soft trade and investment. Inflation language is likely to be left intact (“running below”) and measures of inflation expectations little changed and low. The directional risks to such expectations are geared more toward downgrading the language (e.g. less ‘solid’ job growth, softer consumption growth etc) which could be awkward if the Fed were to signal the end of the easing cycle.

Short-term funding markets—Further measures?

On this the issue is the debate over whether the Fed has done enough or needs to introduce longer-lived solutions. Pressures in short-term funding markets remain significant.

Thus far, they have been addressed through two primary policy instruments. One has been overnight and term repo auctions (charts 2–3 and the rolling gross sums in chart 4) that have been marked by high take-up rates. The October 11th inter-meeting announcement indicated that term repo operations would be held twice weekly starting at US\$35 billion per operation and this was recently raised to US\$45 billion per operation. The same statement announced daily overnight repo operations would be conducted at US\$75 billion or more per operation. Both sets of repo operations would continue at least through January.

Secondly, the same announcement on October 11th introduced plans to purchase Treasury bills at an initial pace of US\$60 billion per month from mid-October to mid-November. In all of these cases, the Fed has used language describing the amounts and periods of operation that has connoted flexibility to do more if needed (“at least”) and so it’s possible that the Fed believes it has better and sufficient market infrastructure in place to address future month-end and quarter-end funding pressures or lumpy issuance and tax payment requirements for liquidity.

Notwithstanding this point, **there remains a solid case for introducing a standing fixed rate repo facility at this meeting.** Such a facility would swap Treasury securities for cash at an interest rate slightly above normal repo rates. The purpose would be to add an extra layer of insulation against funding market dysfunction in such fashion as to mitigate scope for abuse but at the same time set a firmer ceiling to short-term rates.

Press conference—Revised balance sheet targets?

In addition to discussing the above matters, what I’d like to hear Chair Powell address is **fresher thinking from the Fed on the optimal size of excess reserves, by extension the optimal size of the balance sheet, and how they think it should grow in relation to the size of the economy going forward.** These are complex issues with no right or wrong answer and Powell can’t be specific. It may nevertheless be helpful to markets to suggest whether they will do what market conditions dictate or if they are brave enough to attach broad ranges to these variables. It’s more likely that Powell will indicate that the Fed will act as appropriate around a range of possible outcomes as market experimentation is required. Expect Powell to nevertheless repeat this is not ‘QE redux’, as the focus is upon buying short-term securities rather than longer-dated notes.

Also watch for Vice Chair Clarida’s speech before the Japan Society of New York on Friday ([here](#)). The natural temptation is to draw a link to whether the US truly faces the Japanese inflation experience.

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