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An insurance cut won't be enough

Fed special

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Contents

Summary

- The escalation of the US-China trade war and the resulting turmoil in financial markets has finally opened the Fed's eyes that the hiking cycle is over and that the next move should be a rate cut.
- Recent comments by Fed speakers show that they are thinking about the possibility of an insurance cut in the target range for the federal funds rate before the end of the year.
- While the continued inflation undershoot is mentioned as one of the two reasons for an insurance cut, the main reason is the recent escalation in the trade wars and its impact on markets.
- However, we think that an insurance cut will prove to be insufficient. More likely, the threat of a recession will force the Fed to start a full-blown cutting cycle in 2020.
- Our recession probability model, based on the yield curve, now indicates an 83% probability of a recession by October 2020.
- While we stick to our forecast of a full-blown cutting cycle starting in 2020, the risk of an insurance cut in 2019 has risen significantly. The likelihood and timing will depend on developments in the trade wars, the reaction in the financial markets, and the impact on economic data. A decline in inflation would give the Fed an additional argument for an insurance cut.

The Fed's U-turn

Only two weeks ago, the minutes of the FOMC meeting on April 30 and May 1 stressed that a patient approach to determine future adjustments to the target range for the federal funds rate would likely remain appropriate for *some time*. What's more, at the post-meeting press conference on May 1 Chairman Jerome Powell said that the FOMC did not see a strong case for a rate move either way. In fact, if anything, the most recent dot plot – published in March – still implied a rate hike in 2020.

However, this was before the US-China trade war escalated and financial markets started to price in a less optimistic scenario for the global economy. Then last week, on May 30, Vice Chairman Richard **Clarida** opened the door to a rate cut when he said that 'if the incoming data were to show a persistent shortfall in inflation below our 2 percent objective or were it to indicate that global economic and financial developments present a material downside risk to our baseline outlook, then these are developments that the Committee would take into account in assessing the appropriate stance for monetary policy.' While this is a conditional statement, not a plea for a rate cut, it does reflect a bias toward cutting rates instead of hiking.

However, the timing of such an insurance cut will be up for debate. Even the two ultra-doves in the FOMC disagree. In fact, a day later, on May 31, ultra-dove Neel **Kashkari** (Minneapolis Fed, non-voting in 2019, voting in 2020 though) said that 'it's too early for the Federal Reserve to begin cutting rates despite increasing concerns about low inflation and an escalating trade war.' He said 'I'm not quite there yet. I take a lot of comfort from the fact that the job market continues to be strong.' In contrast, a few days later, on June 3, fellow ultra-dove James **Bullard** (St. Louis Fed, voting in 2019) made a plea for a near-term rate cut, when he said that 'a downward policy rate adjustment may be warranted soon to help re-center inflation and inflation expectations at target and also provide some insurance in case of a sharper-than-expected slowdown.' Note that 'soon' is often used in Fedspeak to indicate the next meeting of the FOMC.

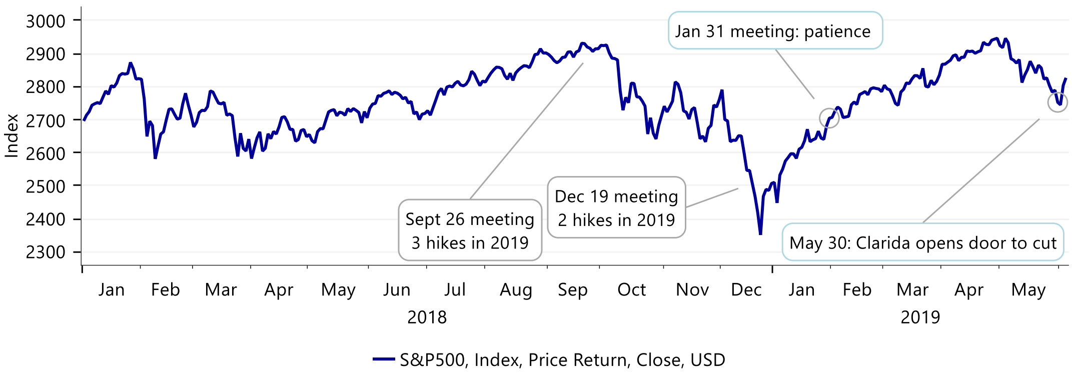
Charles **Evans** (Chicago Fed, voting in 2019), on June 4, indicated that he was in no rush to move rates now and that he tried mostly not to overreact to the trade news. He said 'I'm pretty comfortable with where we are at the moment, but there is uncertainty for sure.'

Later on June 4, Chairman Jay **Powell** more or less repeated Clarida's conditional statement when he said that 'we are closely monitoring the implications of these developments (he was talking about the trade negotiations) for the US economic outlook and, as always, we will act as appropriate to sustain the expansion.'

During a Bloomberg interview on June 5, Robert **Kaplan** (Dallas Fed, not voting in 2019, but voting in 2020) when talking about rate cuts said that 'it's too early to make a judgment on that.' He added that 'I would need to see some evidence that there's a further deceleration in the economy.'

So while the Fed has opened the door to rate cuts, the timing is still highly uncertain. What is certain however is that the 'patience for some time' has gone out of the door and at last the FOMC has come to realize that the hiking cycle has ended.

Figure 1: The impact of the stock market on the Fed



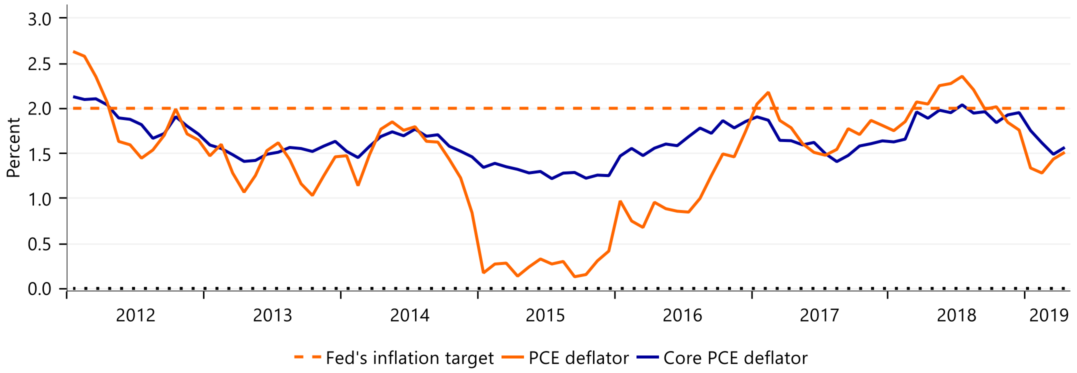
Source: Macrobond

What does it take to cut?

The Fed's change of heart has no doubt been inspired by the turmoil in financial markets in response to the breakdown in the US-China trade negotiations. In that sense, this episode reminds us very much of the Fed's change of mind in reaction to the December 2018 declines in the stock market (Figure 1). By January, the Fed had removed all 3 rate hikes it had in mind for 2019.

However, the exact timing of a rate cut will depend not only on market turmoil (unless we see a crash), but also on the impact of the trade war on the domestic economic data. The direct impact of tariffs on economic growth is too small to affect US GDP growth by more than a few tenths of a percentage point. However, the impact on confidence among businesses and consumers, amplified by declines in stock prices, could have a larger effect. Therefore, the Fed will closely monitor the incoming economic data to see whether there are signs that the expansion is seriously threatened. Of course, the Fed will also drag the inflation undershoot (Figure 2) into its arguments for a rate cut, but on its own it did not seem to be a reason to cut this year.

Figure 2: Undershooting the Fed's inflation target



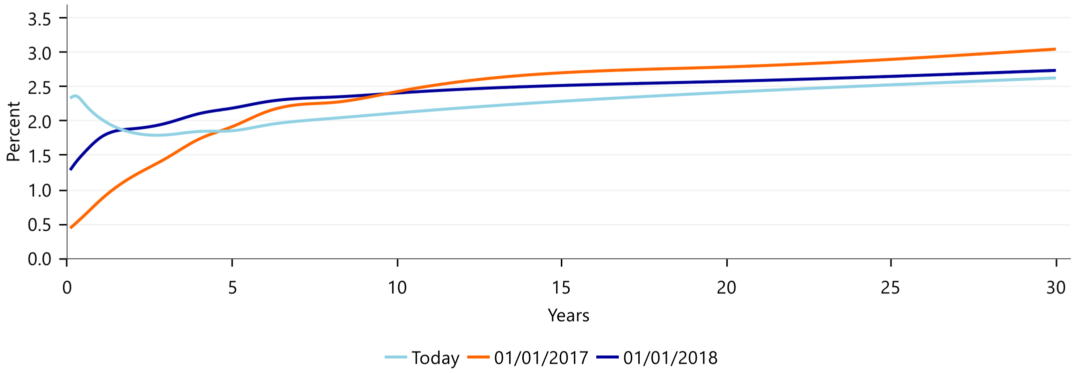
Source: Macrobond

Insurance cut vs cutting cycle

The two reasons mentioned by Fed speakers that might make them decide to cut rates this year are the escalating trade war and the sustained inflation undershoot. However, in both cases we could call such a move an '**insurance cut**.' In fact, in an interview with CNBC on April 11 Fed Vice Clarida exactly used this term to describe a rate cut that is not associated with a recession. In this case the Fed would make a single cut, or perhaps a couple of cuts with some time in between, aimed at preventing unwanted developments such as sustained low inflation or a slowdown in economic growth. It should be seen as fine-tuning the stance of monetary policy, rather than a radical change.

In contrast, since November last year we have a full-blown **cutting cycle** in our baseline Fed forecasts for 2020 on the expectation that the US economy will fall into a recession in the second half of next year. Instead of a single or a couple of isolated cuts to tweak monetary policy, this means a series of rate cuts at each meeting of the FOMC. In our baseline forecasts, we expect the Fed to start cutting at the June 2020 meeting, followed by a similar rate cut at each following meeting until January 2021, bringing the top of the target range for the federal funds rate to 1.00% from 2.50%. To summarize, 5 rate cuts of 25 bps in 2020 and 1 in 2021. While this decline may seem steep, we should keep in mind that you cannot fight a recession with only one or two rate cuts. What's more, since we assume only a shallow recession of two quarters of modestly negative GDP growth in the second half of 2020, we have not even put a 50 bps rate cut or emergency rate cuts (i.e. outside of regularly planned FOMC meetings) in our spreadsheets. This would become appropriate however, if the recession is accompanied by a financial crisis.

Figure 3: US treasury yield curve inversion

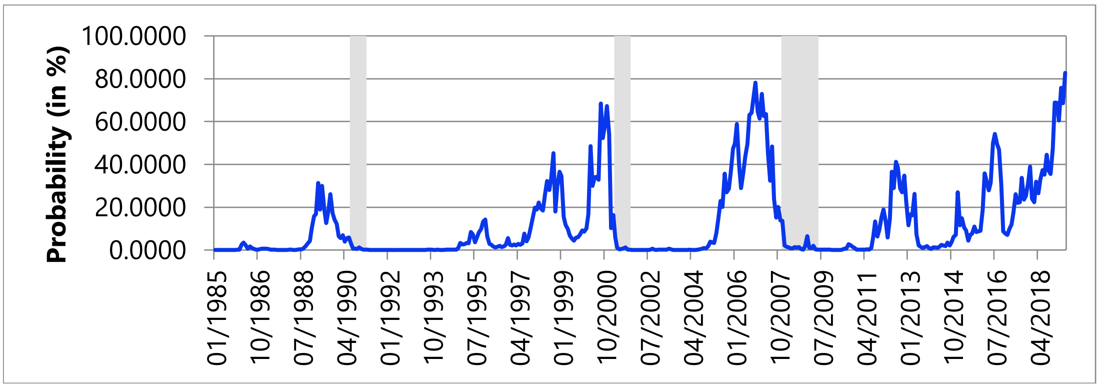


Source: Macrobond

Inversion means recession means cutting cycle

Why did we put a full-blown cutting cycle in our baseline Fed forecasts for 2020 in November last year? At the time the FOMC was heading toward its 4th hike of 2018 and intended to hike 3 times in 2019. However, the Fed's dismissive view of the yield curve as a recession signal led us to the conclusion that the FOMC was going to hike the yield curve into an inversion and therefore tighten monetary policy too much which would in the end lead to a recession. Taking into account the impact of Fed hikes on the yield curve and the historical lags between inversion and recession we assumed that the recession would hit the US in the second half of 2020. This implied that the Fed would be forced to start a full-blown cutting cycle in 2020. While at the time we were way out of consensus, the markets and the Fed have come to agree with us that the hiking cycle has ended and that the next move will be a cut. In fact, based on the current inversion of the yield curve, our recession probability model now indicates an 83% probability of a recession by October 2020.

Figure 4: Recession probability has risen to 83% by October 2020



Source: Rabobank

Conclusion

The escalation of the US-China trade war and the resulting turmoil in financial markets has finally opened the Fed's eyes that the hiking cycle is over and that the next move should be a rate cut. While we stick to our forecast of a full-blown cutting cycle starting in 2020, the risk of an insurance cut in 2019 has risen significantly. The likelihood and timing will depend on developments in the trade wars, the reaction in the financial markets, and the impact on economic data. A decline in inflation would give the Fed an additional argument for an insurance cut.

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