Repossessed

FOMC Post-Meeting Comment

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Contents

Summary

- The Fed cut the target range for the federal funds rate by 25 bps, but the IOER rate and the O/N RRP rate were cut by 30 bps in reaction to the repo turmoil this week.
- However, a more lasting effect would be achieved by raising the level of reserves in the system and launching a standing repo facility. Unfortunately, the Fed is not ready to take these decisions yet. Consequently, we are likely to see more overnight repo operations by the New York Fed in the near term.
- We stick to our view that the feedback loop between trade policy and monetary policy is likely to lead to another insurance cut before the end of the year, but we change our call for the most likely timing from October to December as the divergence of views in the FOMC appears to be leading to temporary policy paralysis on the fed funds rate. In fact, there were three dissenters today. Rosengren and George were against lowering the fed funds rate; in contrast Bullard wanted a 50 bps cut.
- Instead, it does seem that 'organic growth' of the level of reserves will be high on the agenda of the October meeting. The main challenge will be to sell this to the public as something other than QE.
- Meanwhile, in our view the inverted yield curve points to a recession in 2020 that will force the Fed to cut rates all the way to zero before the end of 2020.
- Finally, this week's repo squeeze may be symptomatic of a wider liquidity problem. Due to post-crisis regulation banks are no longer taking the risks necessary to keep the plumbing of the financial system open in times of stress. If the US economy slides into a recession liquidity problems could pop up everywhere. In the worst case, it could turn a run-of-the-mill recession through a financial crisis into something worse.

Repo response

As widely expected, the FOMC cut the target range for the federal funds rate by 25 bps to 1.75-2.00%. However, the turmoil in the repo market this week and the effective federal funds rate climbing outside the target range (figure 1) has forced the Fed into additional action. After overnight repo operations by the New York Fed, the Board of Governors and the FOMC decided today to cut the IOER rate and the O/N RRP rate by 30 bps instead of 25 bps. During his press conference Powell said the Fed was surprised by the strength of the repo squeeze. Although Powell would not admit it, the extra cut in the IOER rate (to 1.80%) and the O/N RRP rate (to 1.70%) suggests that the Fed is afraid of losing control of its monetary policy framework. After all, if they had perceived this week's extreme spike in the repo rate as a one-off, the overnight repo operations by the New York Fed would suffice.

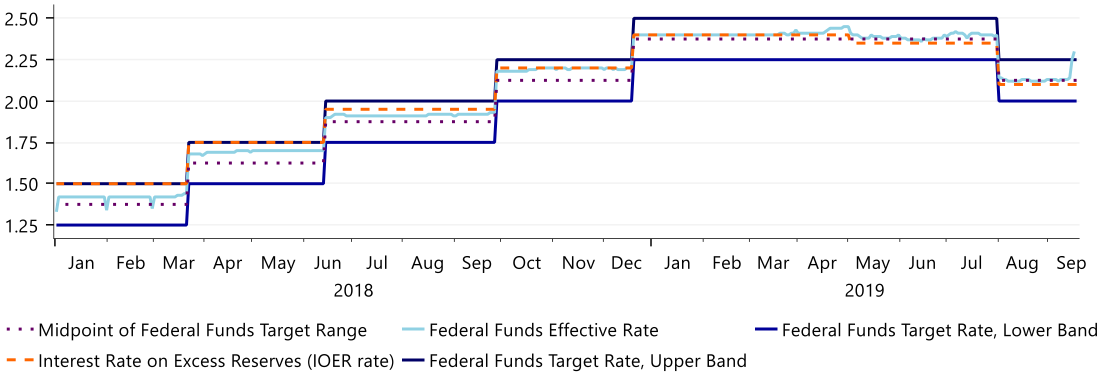
So it seems they fear the next spike could be as severe as this week's, and therefore they made a larger cut to the IOER rate and the O/N RRP rate than to the target range for the federal funds rate. However, a more lasting effect would be achieved by raising the level of reserves in the system and launching a standing repo facility. Unfortunately, the Fed is not ready to take these decisions yet. Consequently, we are likely to see more overnight repo operations by the New York Fed in the near term.

Divided we take our time

Returning to the Fed's main policy rate, the federal funds rate, there were no less than 3 dissenters. What's more, the votes against today's decision came from both sides of the spectrum. On the hawkish side, Rosengren and George were against today's cut. On the dovish side, Bullard wanted a 50 bps cut. The divisions are also visible in the economic projections. The dot plot shows that only 7 out of 17 FOMC participants expect another rate cut before the end of the year. In contrast, the dot plot implies that 5 participants prefer rates to have remained unchanged today. The remaining 5 participants – including the median participant – expect the fed funds rate to stay at today's new level in 2019. We think that this is too optimistic, but it may take some time before there is a majority in the Committee for another insurance cut. Therefore, we change our call for the next insurance cut from October to December. However, this means that we stick to our call for a third insurance cut before the end of the year, after July and September. Note that the previous rate projections, made in June, still showed zero rate cuts for 2019. This was followed by a rate cut in July and September. This shows that questioning the Fed's rate projections is good practice. What's more, the FOMC statement was tweaked only minimally and the promise to 'act as appropriate to sustain the expansion' remained in the text.

Meanwhile, it does seem that 'organic growth' of the level of reserves will be high on the agenda of the October meeting. The main challenge will be to sell this to the public as something other than QE.

Figure 1: Fed funds rate and IOER rate

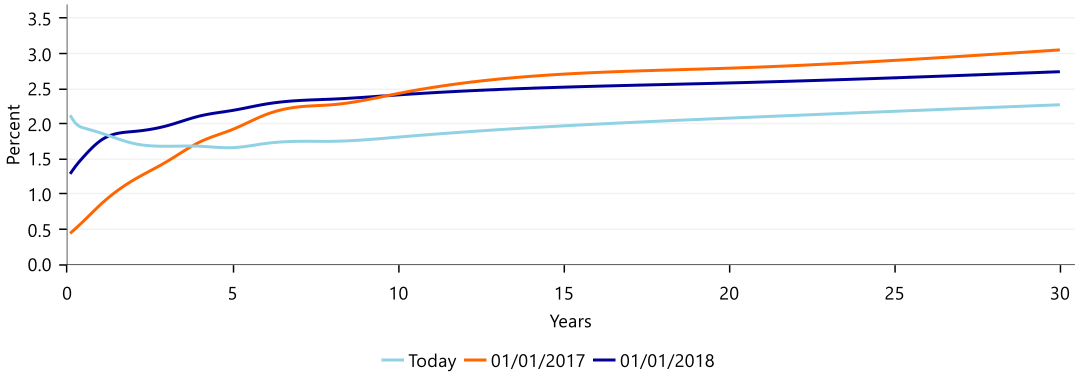


Source: Macrobond

Feedback loop to next insurance cut

President Trump tweeted *'Jay Powell and the Federal Reserve Fail Again. No "guts," no sense, no vision! A terrible communicator!'* While the Fed is trying to ignore President Trump's criticism on monetary policy, the central bank has managed to get itself entangled in his trade policies. As we explained in 'Fed back to zero', by taking a risk management approach to trade policy uncertainty, the Fed is amplifying the effect of trade policy on monetary policy. All Trump needs to do is raise tariffs or take another protectionist measure to get the Fed to cut rates further. In fact, the Fed is enabling the US administration to be tough on trade as the central bank has promised to offset any expected negative impact on the US economy by cutting rates in advance. This means that the Fed is bolstering Trump's bargaining position in the 'game of chicken' between the US and China that we analyzed a few years ago in 'The Trump Trade War Game'. But it also makes it more likely that President Trump will continue to escalate the trade war. And that makes it more likely that the Fed will have to make an additional insurance cut. Consequently, there is now a strong feedback loop between trade policy and monetary policy that will force the FOMC to make a third insurance cut before the end of the year. We now think this is most likely to occur in December.

Figure 2: Inverted yield curve



Source: Macrobond

Inversion signals recession cuts

What's more, we think that this is only the beginning. The inversion of the yield curve (figure 2) points to a recession in 2020H2. While the Fed is downplaying this signal because quantitative easing is supposed to be distorting the yield curve, in our recent special [Yield curve inversion: This time is not different] we showed that the Fed's argument is both flawed and contradicted by the data. Therefore, the recession signals given by the yield curve should be taken seriously. In fact, we have a recession in 2020H2 in our baseline scenario that will force the Fed to go all the way back to zero next year. In fact, at the press conference Powell said that if the economy weakens more, the FOMC is willing to be aggressive. So the reaction function is in place, all we need is to wait for the Fed to fill in the right inputs. However, in the current economic projections, the Fed expects 2.0% GDP growth in 2020 and rate *hikes* in 2021 and 2022! Our updated full forecast of the Fed's rate path is summarized in table 1.

Table 1: Rabobank forecasts of FOMC decisions

FOMC meeting	*Decision*	*Target range for the federal funds rate*
		1.75-2.00
30 Oct 2019		1.75-2.00
11 Dec 2019	25 bps insurance cut	1.50-1.75
29 Jan 2020		1.50-1.75
18 Mar 2020		1.50-1.75
29 Apr 2020	25 bps slowdown cut	1.25-1.50
10 June 2020	25 bps recession cut	1.00-1.25
29 July 2020	25 bps recession cut	0.75-1.00
16 Sept 2020	25 bps recession cut	0.50-0.75
5 Nov 2020	25 bps recession cut	0.25-0.50
16 Dec 2020	25 bps recession cut	0.00-0.25

Source: Rabobank

Repo squeeze part of a larger liquidity problem?

A final thought on this week's repo turmoil. Spikes in repo markets are not uncommon, in fact they tend to take place at specific dates. However, the size of this week's spike shows that there is something wrong with the architecture of US money markets. While the consequences were still limited when the Fed's balance sheet was large, now that reserves have been reduced by almost half from its peak, the cracks have become more visible. While the Fed could fix the repo markets by inundating the system with reserves again and creating a standing repo facility, the underlying problem remains. Evidently, liquidity is a problem at times when everybody wants to go through the same door. Mostly due to post-crisis regulation banks are no longer taking the risks necessary to keep the plumbing of the financial system open in times of stress. At the same time, the size of end users has increased. This means that the Fed has to step in – even if it is only through a standing repo facility – every time investors all head into the same direction.

Also, we should keep in mind that this week's repo squeeze took place under relatively normal circumstances. What if the US economy were to slide into a recession, in line with our baseline scenario? Liquidity problems could then pop up everywhere. In the worst case, it could turn a run-of-the-mill recession through a financial crisis into something worse.

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