The Fed is almost there

FOMC Post-Meeting Comment

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Summary

- The FOMC statement, Powell's press conference and the dot plot support our forecast that the Fed will cut by 25 bps at the next meeting in July.
- In fact, they also support our view that the risk of one or more additional insurance cuts before the end of the year is substantial.
- However, this will not be enough and we expect a full-blown cutting cycle starting in 2020.

Introduction

Today the FOMC layed the groundwork for an insurance cut in the target range for the federal funds rate in July. The formal statement, the dot plot and Powell's press conference all give the impression that the Committee only needs some more data confirming that downside risks to the outlook have risen before pulling the trigger.

Statement

The phrase that the Committee will be *patient* as it determines future adjustments to the target range for the federal funds rate was removed from the FOMC statement and instead a phrase was added that uncertainties about the outlook have increased and in light of these uncertainties and muted inflation pressures, the Committee will *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. This was very close to what Powell said during his prepared speech on June 4. It is the conditional statement that we expected the Fed would use to indicate that it is willing to cut rates if warranted. In fact, Bullard voted against today's decision to keep the target range unchanged because he preferred at this meeting to cut by 25 bps. He was the only FOMC participant who publicly advocated a June rate cut. The FOMC statement also noted that market-based measures of inflation have declined.

Dot plot

Beneath the surface of an unchanged median rate projection for 2019, the dot plot showed a wide divergence of views. Seven participants expected to cut by 50 bps before the end of the year, one participant by 25 bps. In contrast, 8 participants expected rates to remain unchanged through 2019. And one participant expected to hike by 25 bps. So the median obscures a skew in favor of rate cuts. In fact, if only one participant who now expects rates to remain unchanged decides to shift toward a cut, the median will decline by 25 bps. So the median FOMC participant is now very close to a 25 bps rate cut. And 7 (out of 17) participants are already convinced that two rate cuts of 25 bps will be needed before the end of the year.

The median rate projection for 2020 was revised downward sharply from 2.6% to 2.1%, replacing the implied hike in the March dot plot by a cut. However, if the unstable median for 2019 drops a quarter, that cut will take place in 2019 instead of 2020. The Fed remains optimistic however as it expects to hike once in 2021. So in the Fed's scenario an insurance cut will be enough to avert a recession. In our view that is wishful thinking.

In their forecasts for the economy, the participants are actually more optimistic about unemployment in 2019-2021 and 2020 GDP. In contrast, there is a significant downward shift in PCE inflation expectations for 2019-2020. So in addition to the downside risks to real economic growth, the sustained inflation undershoot contributes to the justification of one or more rate cuts.

Again there was a downward adjustment in the longer run forecast for the unemployment rate as wage pressures remain muted despite low unemployment. With the Phillips curve still invisible the NAIRU is clearly lower than where the Fed thought it was. There was also a downward adjustment in the longer run forecast for the federal funds rate to 2.5% from 2.8%. So the Fed has realized it has come closer to neutral than it had thought earlier. In fact, given the inversion of the yield curve we continue to argue that they have already brought the federal funds rate in recession territory.

Press conference

At his press conference, Chairman Powell said that the baseline outlook remains favorable, but the risk of less favorable outcomes has risen. He said that even the participants who expected rates to remain unchanged thought that the case for more accommodative policy has strengthened. Powell indicated that since the developments were very recent, they needed more data and information to see if it is sustained. But he expects to have enough data and information before the next meeting. So if there is no major change, we may conclude that the FOMC will cut in July. Powell also noted that if you are close to the zero bound it is better to act in time, making an argument in favor of an insurance cut. In his answer to the last question in the press conference Powell said that the Fed would be willing to change its balance sheet policy if they decide to provide more accommodation. Note that at present, the Fed is still normalizing the balance sheet with a cap of $15bn/month with the intention of keeping the size of the balance sheet constant from September. So in case of a July rate cut, the Fed may decide to terminate balance sheet normalization – which can be seen as monetary tightening – as well.

Conclusion

The FOMC statement, Powell's press conference and the dot plot support our forecast that the Fed will cut by 25 bps at the next meeting in July. In fact, they also support our view that the risk of one or more additional insurance cuts before the end of the year is substantial. However, as we explained in our FOMC Preview, this will not be enough and we expect a full-blown cutting cycle starting in 2020.

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