Mid-Cycle Delusion

FOMC Post-Meeting Comment

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Contents

Summary

- As widely expected, the Fed decided to cut the target range for the federal funds rate by 25 bps. The IOER rate was reduced by 25 bps as well.
- As we highlighted in our preview, the FOMC decided to put an early stop to balance sheet normalization. The Fed will conclude the reduction of its securities holdings by August 1, two months earlier than previously indicated.
- As we noted in our preview, Eric Rosengren and Esther George voted against today's decision, because they preferred to keep the target range for the federal funds rate unchanged.
- The formal FOMC statement signals the risk of one or more additional insurance cuts in the coming quarters. However, the measured tone of the FOMC statement and Powell's press conference may have dampened the exuberant expectations of rate cuts in 2019 that were priced in by the markets.
- The Fed thinks that this is merely a mid-cycle adjustment to monetary policy. In contrast, we think that a recession is closer than the Fed suspects. Therefore, we expect a full-blown cutting cycle starting in 2020.

Mid-cycle insurance cut

Today's rate cut was well-telegraphed. The FOMC decided to lower the target range for the federal funds rate to 2.00-2.25% (from 2.25-2.50%) in light of the implications of global developments for the economic outlook as well as muted inflation pressures. The Board of Governors reduced the IOER rate in lockstep to 2.10% (from 2.35%).

More importantly, the formal statement signalled that the FOMC is considering additional insurance cuts. The FOMC thinks 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 *<u>uncertainties</u> about this outlook remain. As the Committee <u>contemplates the future path</u> of the target range for the federal funds rate, it will <u>continue to monitor</u> the implications of incoming information for the economic outlook and <u>will act as appropriate</u> to sustain the expansion, with a strong labor market and inflation near its symmetric 2 percent objective*.' In his press conference, Chairman Powell did not give much guidance on what would induce the Committee to make additional insurance cuts. However, he did stress that this was not the beginning of a lengthy cutting cycle, rather this should be seen as a mid-cycle adjustment to monetary policy.

As we noted in our preview, Eric Rosengren (Boston Fed) and Esther George (Kansas City Fed) voted against today's decision, because they preferred to keep the target range for the federal funds rate unchanged.

Freeze the balance sheet

As we highlighted in our preview, the FOMC decided to put an early stop to balance sheet normalization. The Fed will conclude the reduction of its securities holdings by August 1, two months earlier than previously indicated. Until today, the Fed was 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. While two months may not matter much, it would be inconsistent to continue tightening monetary policy through balance reduction while at the same time easing monetary policy through a rate cut.

Taking credit for a policy mistake?

Interestingly, Powell said that the Fed deserved credit for the shift from a hiking cycle to patience to an insurance cut. Through these shifts longer-term rates declined and provided support to the economic expansion. However, we would like to point out that longer-term rates were pushed up by the Fed's hiking cycle in the first place. And if you hike in December and then cut in July, it looks like you made a policy mistake in December. As we wrote at the time the Fed seemed to have become overconfident and only after the stock market took a dive did the Fed change its tune. So taking credit for these shifts in the rate outlook and their contribution to the sustained economic expansion seems a bit much.

Mid-cycle delusion

Given the lack of progress in the US-China trade negotiations, the uncertainty that the Fed is referring to in its justification of an insurance cut is likely to persist. Meanwhile, recent economic data suggest that uncertainty about trade and global growth are weighing on business investment. In fact, business investment declined by 0.6% in Q2 (quarter-on-quarter, at an annualized rate). Therefore, there is a significant risk that the Fed will add **one or more insurance cuts** in the coming quarters. However, the measured tone of the FOMC statement and Powell's press conference may have dampened the exuberant expectations of rate cuts in 2019 that were priced in by the markets.

Unfortunately, even if the Fed were to add more insurance cuts, we think that they will not succeed in averting the next recession. In our view the Fed's so-called mid-cycle adjustment will morph into a **full-blown cutting cycle** during the course of next year. Historically, yield curve inversions are followed by recessions in 12-18 months. What's more, residential investment – the most interest-rate sensitive component of GDP – has been falling for six quarters in a row.

Instead of a single or a couple of isolated cuts to tweak monetary policy, a cutting cycle means a series of rate cuts at each meeting of the FOMC. In our baseline forecasts, we expect the Fed to start this cycle 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 0.75% from 2.25%. To summarize, we expect 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. In a recent special we discussed through which channels the rise in business debt and its partial securitization through CLOs could be a possible risk factor. However, for now we maintain a run-of-the-mill recession in our baseline scenario.

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