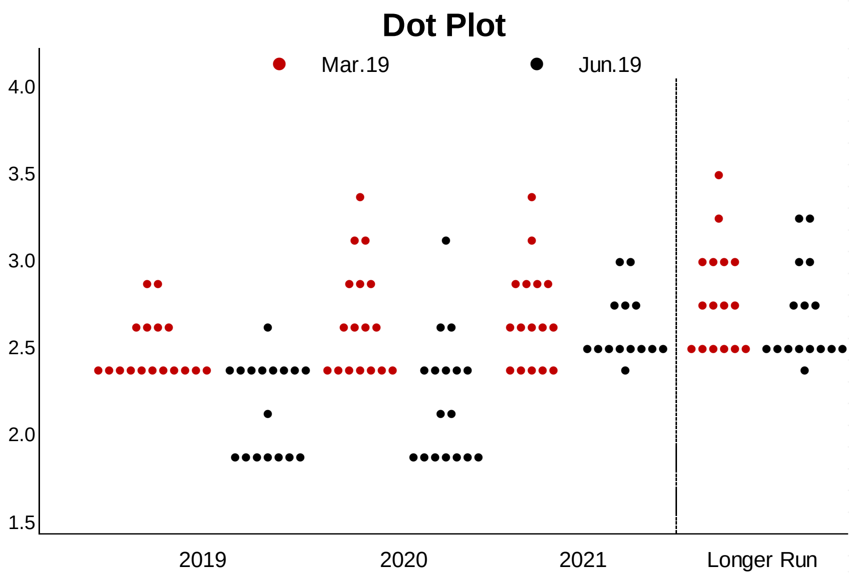
GIAM Macro & Market Research - Market Commentary

The Fed has almost lost patience: dots show strong support for cuts in 2019

- **Rising risks to growth have convinced a large number (eight out on seventeen) of FOMC members that rate cuts are needed by the end of the year.**
- **The macro forecasts have not changed significantly, showing that accommodation is meant to avoid tail risks to the economy. Inflation is expected to go back to 2% at a slower pace.**
- **We confirm our view of a 50 bps reduction by the end of the year, with the fist cut in July. Risks are tilted towards a more aggressive move.**

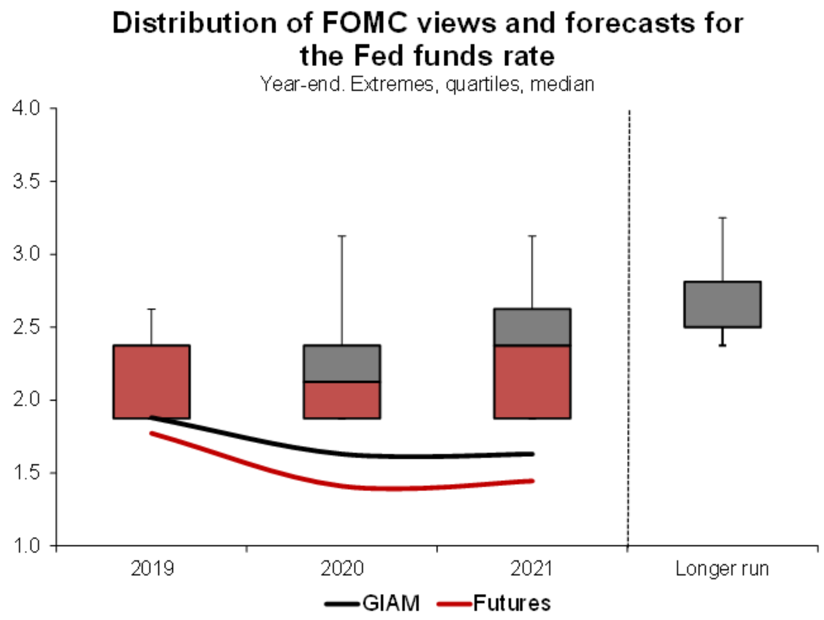
The Fed is taking very seriously the increasing risks to growth, and acknowledges that **the crosscurrents the economy is facing are stronger and more persistent than what previously thought;** therefore, a strong response may be needed. Consistent to its stated data driven approach, however, **it stopped short of signaling a rate cut already in 2019, also in an effort to buy time in order to look at the most recent developments** especially on global growth and trade.

While the median dot for this year has not changed, **seven out of seventeen members deem appropriate a 50 bps rate cut by the end of the year and one is in favor of a 25 bps reduction.** Moreover, Chair Powell stated that **the FOMC members who decided not to move their dots now see a stronger case for accommodation.**



The median dot for 2020 is consistent with a 25 bps rate cut, while that for 2021 signal a 25 bps hike. In the scenario painted by the dots **the economy is facing a temporary slowdown, which would be smoothed by some trimming in the Fed find rates.**

We see today's drastic change in tone as a way to anticipate a cut, which we will see in July. We expect an overall 50 bps cut in the second half of the year. Our baseline foresees a 25 bps cut in July followed by another in September. Should incoming data signal a faster deterioration of the outlook, and/or should trade talks with China fail, the Fed funds rate could be cut by a full 50 bps in July.



The strong "insurance" rationale behind the dovish twist is evident given the limited changes to the economic projections. Only the median GDP forecast for 2020 was revised, slightly up, while a marginally lower unemployment path is expected, also in the long run, consistent with the muted response of wages to labor market tightening. **The 2019 forecast for inflation was marked to market quite aggressively, with the headline rate moving from 1.8% to 1.5**% and the core one from 2% to 1.8%. Weaker inflation and risker growth are clearly the drivers of the move towards accommodation.

Possibly the biggest surprise delivered by the economic projections is the **strong reduction of the long run forecast for the policy rate, down to 2.5% from 2.8% in March**. Given that the estimate of long run growth has not changed, we can interpret the marking down of the equilibrium rate as a **reassessment of how far monetary policy normalization can go**. The reduction in the feasible range for policy rates will necessarily **put to the fore other monetary policy tools, first and foremost the Fed's balance sheet.**

	2019	**2020**	**2021**	**Longer run**
Change in real GDP	2.1	2.0	1.8	1.9
March projections	*2.1*	*1.9*	*1.8*	*1.9*
Unemployment rate	3.6	3.7	3.8	4.2
March projections	*3.7*	*3.8*	*3.9*	*4.3*
PCE inflation	1.5	1.9	2.0	2.0
March projections	*1.8*	*2.0*	*2.0*	*2.0*
Core PCE inflation	1.8	1.9	2.0	
March projections	*2.0*	*2.0*	*2.0*	
Appropriate policy path				
Federal funds rate	2.4	2.1	2.4	2.5
March projections	*2.4*	*2.6*	*2.6*	*2.8*

The press statement underwent big changes. The pace of growth has been downgraded from “solid” to “moderate”, and the weakness in capex is flagged. On inflation, the risks of not hitting the 2% target soon are acknowledged. In such a scenario, **“patience” was replaced by a closer monitoring of the incoming data.**

The rationale behind the change was discussed in the press conference:

The growth outlook: overall the economic outlook have worsened since May. The negative cross currents have re-emerged, and the GDP data for Q1 show **that growth relies on rather fragile elements** like trade and inventories. C**apital spending was very weak, and there are indication that this is continuing also in Q2**. Moreover business sentiment is trending down and the manufacturing sector is suffering from an uncertain international outlook. However **some of the headwinds are still quire recent and the Fed will have to digest more data before having a clear picture.**

Labor market: wage growth is now broadly in line with productivity and expected inflation; however, **not seeing a faster pace of wage growth has been a bit of a surprise, possibly indicating that the labor market is not (or not yet) that tight.**

The trade war: Any good news on the Relationship with China will bolster sentiment, but the Fed looks at several indicators on the global economy, not just trade frictions.

Inflation: inflation clearly declined in Q1 and **the FOMC is concerned about the slow pace of recovery towards 2**%. The temporary nature of the weakness in inflation was restated (possibly with less conviction), but it was underlined that **prolonged period of low inflation can feed into expectations, increasing the risk of a permanent decline**. The drop in breakeven rate and the fact that survey measures of expectations are near the bottom of the usual range were explicitly mentioned as reasons for a more accommodative stance.

Monetary policy: The FOMC decided not to cut rates at the June meeting as data not yet support such a move, especially as there is still a big uncertainty on how long the risk factors will linger. **The FOMC has not discussed the optimal size of the next cut**, but the recent literature shows that, **with rates peaking much closer to zero than in the past, a quick a strong action is preferable** in terms of output stabilization. But any decision will depend on the incoming data.

Chair Powell reiterated that the dots are just an input to the discussion and represent just the most likely case. The second most likely could be very different. Quoting a paper presented at the recent Chicago conference: “the dot plot conveys the diversity of views on the Committee, but fails to represent how the Committee is likely to aggregate those views into a consensus”. Still, no alternative to the dots was presented.

As the balance sheet runoff is close to an end, no decision has been taken on whether and how to use it, but Powell underlined that the Fed stands ready to alter it in order to reach its policy goals.

Author:
Paolo Zanghieri
paolo.zanghieri@generali.com