Fed Watch

AIB Treasury Economic Research Unit

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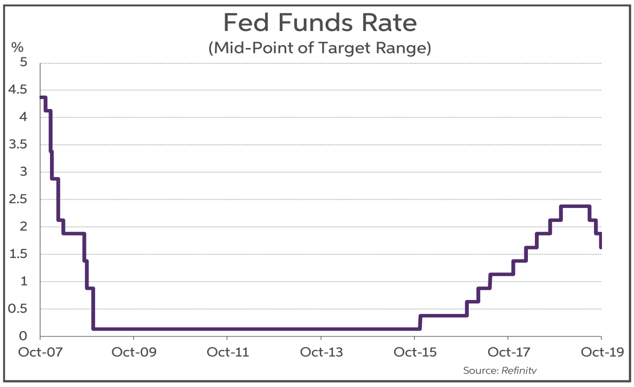
Fed cuts again but indicates now in pause mode

The October meeting of the Federal Reserve Open Market Committee (FOMC) concluded as expected with the central bank once again cutting interest rates by 25bps. The target range for the key fed funds rate was lowered to 1.5-1.75%. This represented the third consecutive meeting that the FOMC has cut rates. As was the case in July and September, the decision to lower interest rates was not unanimous. Once again, FOMC members Rosengren and George voted for no change. However, in a change to the previous meeting, member Bullard did not vote for a 50bps cut in rates and was content with a 25bps reduction.

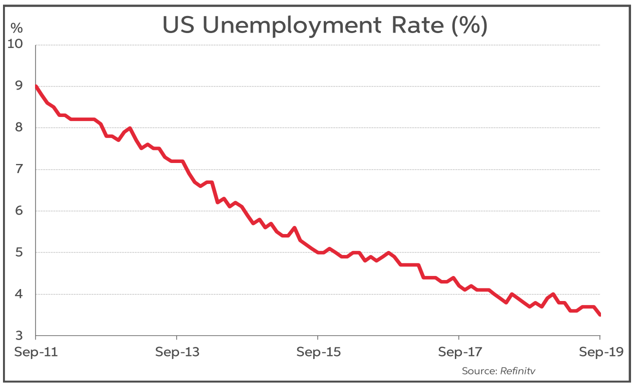
The FOMC statement outlined that the decision to cut rates was taken against the backdrop of the weaker global economic outlook and implications this had for the US economy as well as continuing muted inflationary pressures. In his press conference, Fed Chair Powell, stated that the rate cut was deemed necessary in order to "help keep the US economy strong in the face of global developments" and to "provide some insurance against ongoing risks". The 25bps cut was fully priced in, so the main focus for the market was on the indications the Fed would provide about any further rate cuts.



In this regard, an important change to the meeting statement suggests that the Fed is now in pause mode and that it is not anticipating a need to cut rates further. This was illustrated in the Fed removing its previous pledge to "act as appropriate to sustain the expansion". Instead it is now stating that it will "assess the appropriate path" for the Fed funds rate.

Chair Powell commented that for the Fed to cut rates further it would require a "material reassessment" of its economic outlook. In the Q&A, the Fed Chair reinforced this point by stating that the current stance of policy 'is likely to remain appropriate as long as the incoming US macro data is broadly consistent with its outlook". In this regard, the FOMC continues to hold the view that the outlook for the US economy remains "favourable". It is expecting the US economy to grow at a solid pace close to 2% in 2020 and 2021, in line with the current rate of growth.

The most recent set of interest rate projections released back in September showed that there were wide divisions within the FOMC about the future path of US interest rates. In this context, it is interesting to note that no FOMC member believed that rates will be cut below their current level of 1.625% in the next couple of years.



In terms of market expectations, over the last two months there has been a notable paring back of the degree of rate cuts being anticipated. This is in light of some progress in US-China trade talks and caution within the Fed on the need for additional policy easing. Futures contracts now indicate the market is pricing in the Fed cutting rates to around 1.25% from 1% previously.

Overall, while the Fed has not ruled out further rate cuts, it has indicated that it does not envisage easing policy further as long as the incoming data remain consistent with its economic outlook. At the moment it appears content that the three rate cuts it has now implemented will be enough to sustain the economic expansion in the US. Of course, if the US macro data deteriorates and the economy slows further, then the Fed could cut again. Given the meeting outcome was very much in line with expectations, there was no noticeable reaction on markets following its conclusion.

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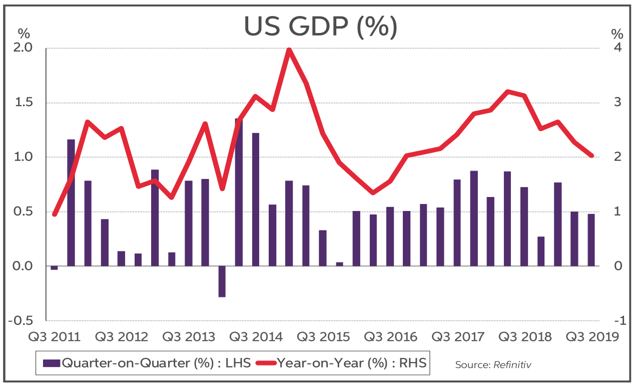
Growth in US economy moderates

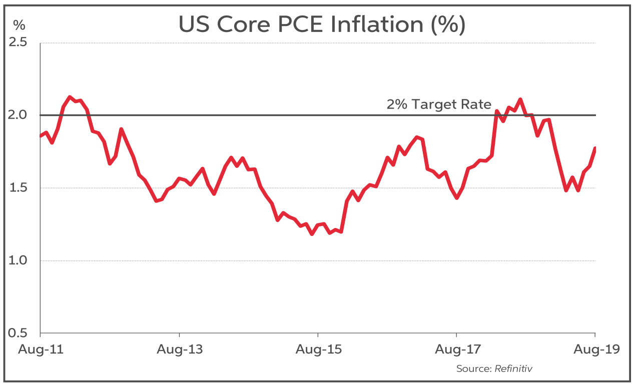


US annualised GDP growth came in at 1.9% in Q3, broadly unchanged from 2.0% in the second quarter. The year-on-year growth rate slowed to 2%, the weakest rate since 2016 and down from circa 3% in 2018. The underlying data showed that consumer spending continued to drive activity in Q3, contributing 1.9 percentage points (p.p.) to the quarterly total. Fiscal policy also remained expansionary, with rising government expenditure adding a further 0.4 p.p. Net trade, changes to inventories and fixed investment all acted as drags, subtracting 0.2, 0.1 and 0.1 p.p., respectively.

Other hard data from Q3 bear out the uneven rate of US growth. The closely watched 'control' measure of retail sales rose by 1.6% in nominal terms over Q2 levels. In contrast, on the output side of the economy, the year-on-year rate of industrial production stands at just 0.1%, despite output having risen by 0.4% in Q3. Furthermore, other indicators, such as the manufacturing ISM, point to a continued weak performance for the sector.

Signs of softness have also began to emerge in the labour market. Payrolls are trending downward, with the average monthly gain coming in at 157k in Q3. This compares to a 223k average in 2018. However, the unemployment rate did fall to a 50-year low of 3.5% in September. Despite the lack of slack in the labour market, wage inflation has moderated, falling back under the 3% level for the first time since July 2018.

On the inflationary front, there has been some evidence of a slight pick up in price pressures. The Fed's preferred measure, core-PCE, was recorded at an annualised rate of 2.2% in Q3, the fastest since the opening quarter of 2018. Meanwhile, the annual core rate of CPI came in at the higher rate of 2.4% in September. Lower oil prices saw headline CPI inflation ease to 1.7% in the same month.



The available survey data for the final quarter of the year suggest that economic activity is unlikely to accelerate in the near term. The manufacturing PMI improved slightly from 51.1 to 51.5 in October, while the services index was unchanged at 51.2, readings consistent with only modest growth. On the demand side of the economy, the University of Michigan measure of consumer sentiment rose from 93.2 to 95.0 in October, while the Conference Board measure fell again in the same month.

To surmise, the US economy has shifted onto a slower growth path. This partly reflects the impact of late cycle dynamics, with the current expansion now the longest on record. Fiscal policy is also now less expansionary. However, policy uncertainty, particularly in relation to trade, is playing a significant role. On this note, there have been signs of some progress in the US-China trade talks. A 'phase 1 trade deal' is expected to be concluded at some stage in November, which could see the US delay/cancel placing tariffs on an additional $300bn worth of Chinese imports in December. An easing in trade tensions would help business confidence, and in turn could lead to some recovery in business investment.

Meanwhile, the Fed's has positioned its monetary policy to remain supportive of activity to ensure that the US expansion continues. The housing market in particular is being helped by the fall in long term interest rates. Additionally, government spending is expected to continue to rise in the immediate future. The Fed is projecting GDP growth of close to 2% over the next two years. This is similar to the IMF, which expects that the economy will expand by 2.1% in 2020 and 1.7% in 2021.

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