Fed Watch

AIB Treasury Economic Research Unit

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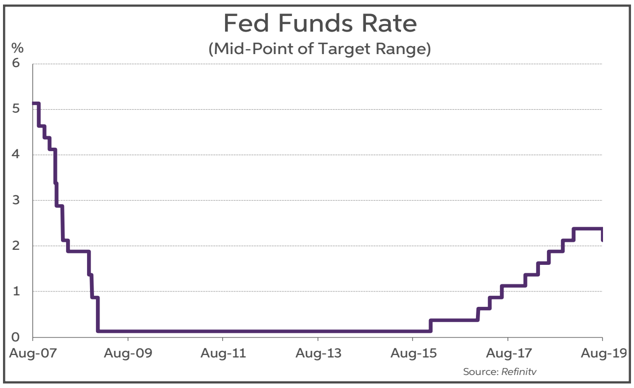
Fed cuts but non-committal on further easing

As was widely anticipated, the July meeting of the Federal Reserve Open Market Committee (FOMC) saw the central bank cut interest rates by 25bps for the first time since 2008. The target range for the key fed funds rate was lowered to 2.00-2.25%.

The decision to lower interest rates was not unanimous, with two members (Esther George and Eric Rosengren) voting for no change. **The Fed also announced that it was ending its balance sheet rundown (i.e. it will start fully reinvesting maturing securities from its QE programme), thereby maintaining the size of its balance sheet.**

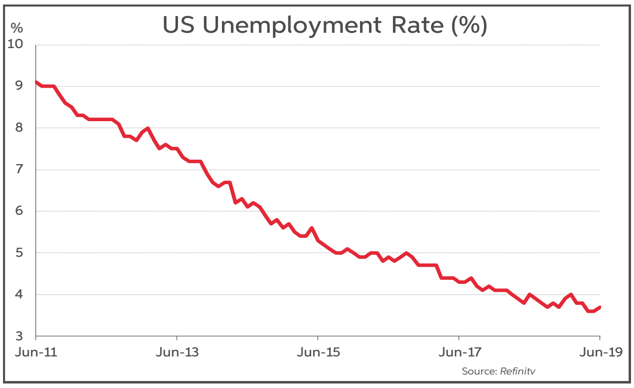
Fed Chair Powell outlined in the press conference the rationale for the Fed's decision to ease policy. He referenced three key reasons behind the announcement. Firstly, he stated that it is intended to "insure against downside risks from weak global growth and trade policy uncertainty". Secondly, he said that the policy easing will help "offset" the effects from the current global macro backdrop. Thirdly, it will help the Fed meet its 2% inflation target. **However, with the 25bps cut already fully priced in by markets, the main focus was on what indications the Fed would give regarding the potential for further rate cuts.**



In this context, Fed Chair Powell emphasised that the rate cut did not herald the start of a lengthy cutting cycle. He stated that a sustained period of rate cuts was not the current policy outlook for the central bank. Instead, he described the rate cut as a "mid cycle adjustment to policy".

The justification given for this position was in the Fed's assessment of the US economy. Chair Powell described the economy's performance as being "reasonably good" and that the "outlook for the US economy remains favourable" and that "nothing" in the US economy "presents a prominent near term threat", with the main downside risks "really coming from abroad".

Following the meeting, the market has pared back somewhat its expectations regarding additional rate cuts from the Fed. Futures contracts indicate that the market is now envisaging around 50bps in further policy easing over the next 12 months. Prior to the meeting, it was pricing in around 75bps in additional rate cuts over this period. In terms of timing, the market is expecting another 25bps rate cut by end October, followed by a further 25bps of easing during the first half of next year.



Overall, the Fed has given a clear signal that this is not the commencement of a sustained cycle of rate cuts. Although, at the same time, the Fed has been careful to keep its options open regarding the interest rate outlook. It has not ruled out further rate cuts. However, it has emphasised that the extent of these would be modest in nature. In this regard, it will be monitoring incoming macro data and the "evolving risk picture", linked in part to global trade tensions, to assess the appropriate stance for its monetary policy.

Judging by the market reaction, the tone from the July Fed meeting disappointed those expecting a more dovish policy outlook. Despite the rate cut announcement, the dollar strengthened on the back of the Fed downplaying the chances of a long rate cutting phase. In level terms, this was reflected in EUR/USD falling below the $1.11 mark, to trade at two year lows. At the same time, Wall Street finished the day lower, with the S&P 500 index down by around 1% at the close last night.

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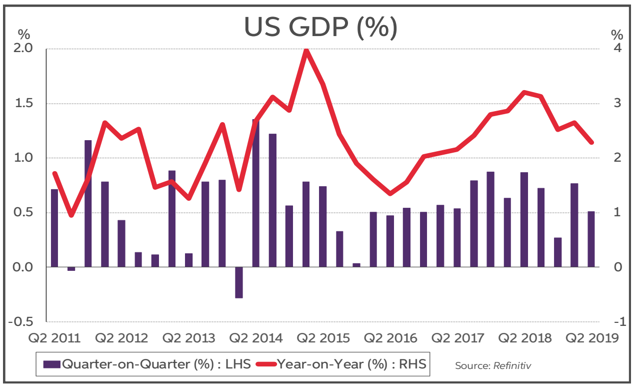
US growth slows in Q2 but remains robust

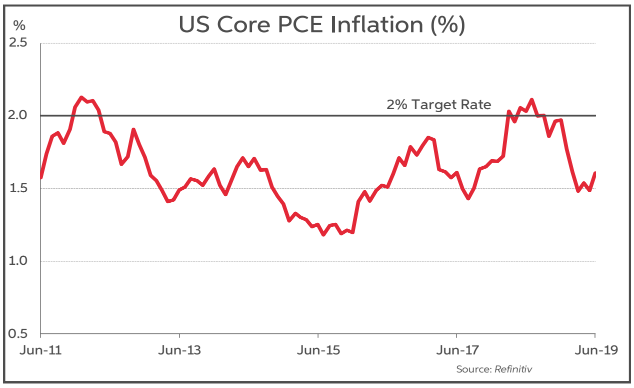
US annualised GDP growth moderated to 2.1% in Q2, from 3.1% in the opening quarter of the year. The underlying breakdown showed that the slowdown was largely related to the unwinding of the temporary boost to growth from a build-up of stocks in Q1. Changes in inventories subtracted 0.9 percentage points (p.p.) from Q2 growth. The external sector and business investment also acted as headwinds, deducting 0.7 and 0.1 p.p. respectively. In contrast, consumer spending was very strong, adding 2.9 p.p., while government expenditure contributed 0.9p.p..



Other hard data from Q2 paint a similarly mixed picture of the US economy. Strong household spending saw retail sales rise in nominal terms by 1.8% on Q1 levels. In contrast, industrial output dipped by 0.3% in the period, as the weaker global environment continues to weigh on activity. The manufacturing sector, in particular, is struggling.

Meantime, the labour market remains in rude health. Non-farm payrolls expanded by a very strong 224k in June, though this did follow May's disappointing 74k figure. Overall, monthly payroll growth in Q2 averaged 171k, a reasonably impressive number given how mature the economic expansion is. The unemployment rate did, though, edge up slightly to 3.7% in June. However, if payroll growth remains as strong in the coming months, it will put downward pressure on the jobless rate. At the same time, the tightness of labour market conditions has seen the year-on-year growth rate of average earnings hover in a 3.0-3.5% range over the past year.

On the inflation front, price pressures remain relatively contained. While the Fed's preferred measure of inflation, core-PCE, rose to 1.8% in June, this is still below the central bank's 2% target. Meanwhile, the core rate of CPI was recorded at the higher rate of 2.1% in the same month. Headline CPI eased to 1.6% in June, largely due to the impact of lower oil prices compared to a year earlier.



The limited survey data available for Q3 have been somewhat disappointing. The flash composite PMI was broadly unchanged in July, at 51.6, suggesting the economy had a muted start to the quarter. This is largely due to the manufacturing index, which has continued to move lower. In contrast, the services PMI is holding up reasonably well. Meanwhile, consumer confidence data remain encouraging, with the University of Michigan and Conference Board readings for July consistent with very solid consumer spending.

To surmise, growth in the US economy slowed somewhat in Q2, but remained solid enough nonetheless. The boost from tax cuts at the beginning of last year is fading. However, a strong labour market should support the key consumer side of the economy (c. 70% GDP). Although, trade tensions between the US and its main trading partners are acting as a headwind. However, the Fed's willingness to "act as appropriate" to ensure that the US expansion continues, suggests that monetary policy should remain supportive of growth. The most recent IMF forecasts are for growth of 2.6% in 2019, followed by 1.9% in 2020.

Over the medium term, there are risks facing the US economy. Of particular concern is slower global economic growth and the aforementioned trade tensions. At the same time, the US expansion is now the longest on record, which therefore calls into question how much longer it can be sustained. Separately, there is a risk of asset price bubbles forming in the US given the strong gains by stock and bond markets in this year in the expectation of significant monetary easing.

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