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Powell testimony and FOMC minutes: Will the first cut be the deepest?

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- Chair Powell's testimony and the minutes to the June FOMC meeting today largely confirmed the Fed's intention to ease monetary policy at their July 31 meeting. As we anticipated, Powell's testimony adhered to his statements from the June 19 post-FOMC press conference. Indeed, Powell went one step further by stating that "Since then, based on incoming data and other developments, it appears that uncertainties around trade tensions and concerns about the strength of the global economy continue to weigh on the U.S. economic outlook. Inflation pressures remain muted."
- In the wake of Powell's testimony and the June minutes, bond market pricing indicates increasing odds of a 50-basis point (bp) rate cut in July. While we continue to expect the Fed to cut 75 bps by year end, we remain of the view that the Fed will ease 25 bps in July, and proceed on a meeting-by-meeting basis as they evaluate the incoming growth and inflation data. In this piece, we weigh the arguments for easing 50 bps in July versus our baseline position that they will ease 25 bps.

The case for 50

While the case for additional policy stimulus at this juncture is strong, we concur with St. Louis Fed President Bullard (voter/dove) that 50 bps of cuts would be overdone. There are two major arguments in favor of a more aggressive initial policy easing which in our view are less compelling than the case for easing policy at a more measured pace, which we cover in the next section.

The first argument is that with the market currently pricing a base case scenario of a 25 bp cut at the July meeting, the Fed would need to cut by more than that in order to boost financial conditions and thus affect growth. Our previous research has shown the primary effect of easier financial conditions is to shore up downside risks to the outlook. However, financial conditions do not seem to be at levels that would be expected to weigh on growth. The most recent reading from our financial conditions index shows +0.12, which is slightly supportive of growth. This, combined with the strong GDP growth reading from Q1 (+3.2% year-over-year), would imply just over a one percent chance of negative growth over the next four quarters. As such, the need to cut over and above what is being priced in by the market would provide limited benefits.

An argument for a 50 bp cut that holds more water is that in a low interest rate environment where the Fed faced the possibility of being constrained by the zero lower bound, it should act more aggressively when facing potential negative shocks to the economy. This has been previously argued by many prominent Fed officials, including New York Fed President Williams (neutral). In fact, Chair Powell himself was asked about this rationale in the press conference after the June meeting. Though he acknowledged the rationale, he ultimately demurred. In the days after the meeting though, Minneapolis Fed President Kashkari (nonvoter/dove) revealed that he advocated for a 50 bp rate cute and a commitment to not raise rates until the Fed hit its 2% target, stating that "an aggressive policy action such as this is required to re-anchor inflation expectations at our target". However, Williams' comments about aggressive action were more in the context of the economy facing deflation risk or a very sharp slowdown, neither of which seem likely given the recent mixed data. In addition, the minutes indicated that some participants thought further easing could prove unnecessary and potentially fuel unwanted imbalances. The latter point was recently made by Dallas Fed President Kaplan (nonvoter/dove).

Finally, some observers would note that when Chairwoman Waters asked Powell about a possible 50 bp move in July, he did not take the opportunity to push back or discourage such expectations. We would note at the same time, neither did he say anything to endorse this view—possibly because there may not be a consensus within the FOMC to move this aggressively. In fact, recent comments by both Philadelphia Fed President Harker (nonvoter/neutral) and Cleveland Fed President Mester (nonvoter/hawk) indicate that they did not think rate cuts were appropriate, opting instead for a wait-and-see approach. This indicates that consensus for a 50 bps cut would be harder to reach than that for a 25 bp cut.

The case for 25

As discussed in the previous section, there is unlikely to be a consensus on the FOMC to ease 50 bps in July even with eight Fed officials calling for rate cuts by year end. Indeed, St. Louis Fed President Bullard (voter/dove), who dissented at the June 19 meeting, reiterated that while he expects the Fed to cut 50 bps by year end, he does not think that the current situation warrants cutting 50 bps at the July 31 meeting. In turn, a 25 bp cut in July appears much more likely in our view.

Recent developments have been mixed, including on the positive side, the resumption of trade negotiations with China, a solid jobs report and a strong stock market. While the Fed can make a good case for easing due to concerns about the global growth outlook against the backdrop of muted inflation pressures, it is also possible that additional rate cuts will prove unnecessary if the data take a more positive turn. In other words, while it makes sense to move preemptively from a risk management perspective, the data do not argue for moving aggressively, especially given the potential for policy easing from other central banks—namely, the ECB.

To be sure, sentiment in favor of 50 may well have gotten a lift because Powell seemed to emphasize the negatives in the picture over the positives. But we read this as the Chair making clear that positive developments since the June meeting have not changed the Committee's bias toward taking some preemptive easing.

Powell’s testimony suggested that policy will be reacting as various developments unfold ahead, which augurs for moving on a meeting-by-meeting gradual approach: "Moreover, a number of government policy issues have yet to be resolved, including trade developments, the federal debt ceiling, and Brexit." The debt ceiling in particular would be relevant for the Sept 18 meeting and the Brexit deadline is October 31, a day after the October FOMC meeting.

Recent Fed commentary, particularly from Chair Powell’s press conference and testimony, also point towards the benefits of a tight labor market. At minimum, they reiterated that the Fed's goal is to sustain the expansion. The input from Fed Listens events regarding positive externalities to labor force participation and productivity growth from tight labor markets seem to have resonated with many Fed officials, such as San Francisco Fed President Daly (nonvoter/dove) as well as Powell himself. With interest rates in the vicinity of neutral, and inflation pressures muted, extending the expansion argues for a more gradual pace of policy adjustment that attempts to reap as many benefits of low interest rates before incurring the costs—i.e. higher inflation or other economic imbalances.

From a political point of view, the optics of a 25 bps interest rate cut seem to be better than those of a 50 bp cut. With the Trump Administration continuing and even increasing its jawboning of Fed officials, doing more than is strictly priced in risks feeding into the mistaken perception that political pressure from the Administration is influencing how the Fed conducts monetary policy. In short, overdoing it could risk a credibility issue.

Another argument against a 50 bps cut is that without projection materials, it risks being misinterpreted and fueling negative narratives that the Fed is seeing something that market participants are missing. In this sense, a 50 bp cut at the September meeting would make much more sense than at the July meeting as Fed officials would have the SEP to back up their statements about the intended effects of such a large rate cut.

Conclusion

While there are certainly arguments to be made in favor of a 50 bps July cut and we are not completely surprised at the market pricing some probability of that outcome, we believe that the balance of the evidence favors an initial 25 bps cut. With a bevy of additional data between the July and September meetings, including two more jobs reports, additional inflation data, and a better view of Q2 growth, the Fed can then ease again in September if there is no dramatic improvement in the data, and at the same time provide a benchmark for market participants to gauge prospects for further easing through the September SEP. With such limited policy space, the Fed will need to be efficient in using its available rate cuts.

Appendix 1

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