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Fed Notes

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July FOMC preview: Taking out an insurance cut

- We expect the Fed to confirm our long-held expectation of a 25bp rate cut at the July meeting. With this easing fully priced by the market, the key question is how Chair Powell and the Committee frame the narrative for further easing through year end. The Committee should maintain an easing bias in its statement and in Powell's presser, with the onus on downside risks to definitively dissipate in order to avoid another cut in September.
- However, the degree of further easing beyond July needed to combat downside risks will be data dependent and the Committee will be evaluating that on a meeting-by-meeting basis. In this respect, we do not expect the Committee to pre-commit to another cut in September. While signals from the meeting statement and press conference are unlikely to intentionally nudge market pricing in a more hawkish direction – indeed, they should be reasonably comfortable with current pricing given an easing bias – this message could result in some market participants dialing back expectations of almost 70 bps of easing through year-end.

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Why a 25bp cut is most likely

The signal from the June FOMC meeting was that crosscurrents had to definitively dissipate and data needed to outperform significantly for a cut not to follow in July. At his Congressional testimony earlier this month, Chair Powell laid the groundwork for a July easing by indicating that the headwinds and muted inflation pressures remain. Subsequent Fedspeak revealed that, while not a unanimous expectation, consensus had built within the Committee around a rate cut next week. Although the recent data have been mixed, as we detailed in our Fed Watcher a few weeks back (see July cut coming, but Fedspeak reveals some fissures), we see a compelling case for easing policy at this point. Indeed, this week's developments, including further softening in global growth momentum and downward revisions to the recent trends in GDP growth and core inflation, have strengthened the case for easier policy.

With a cut nearly assured in July and further cuts likely to follow, why is 25bp most likely? We detailed the reasons for less aggressive action in a recent note (see Powell testimony and FOMC minutes: Will the first cut be the deepest?), but in summary: (1) Fedspeak indicates that 25bp is more likely, with Powell reiterating the case for "somewhat" more accommodative policy, the Committee's most dovish member, St. Louis Fed President Bullard, arguing for this magnitude, several centrist members arguing against any cut at this point, and the NY Fed walking back the dovish market reaction to Williams' speech last week; (2) the data have been mixed but do not indicate an imminent sharp slowdown; (3) financial conditions remain very easy, helping to limit downside risks to the growth outlook; (4) with several risk events on the horizon, including trade developments and Brexit uncertainty, it makes sense to take policy decisions on a meeting-by-meeting basis to save ammunition if risks do in fact materialize; (5) several of the reasons to ease – too low inflation and a desire to run the labor market hot – do not require an aggressive initial response; and (6) a 50bp cut risks hitting confidence and could have bad optics with respect to Fed independence.

Statement

Revisions to the Committee's statement should be relatively minor. Given that key data releases since the June FOMC meeting have on balance surprised to the upside, the statement should maintain its relatively upbeat description of the labor market as "strong" and growth as "rising at a moderate rate." While the description of jobs gains and the unemployment rate should be untouched, it is possible the statement upgrades its description of household spending to "strong" following the robust June retail sales report. Business fixed investment should continue to be described as "soft", however, and inflation as still "running below 2 percent". The final edit to the opening paragraph is likely to be that market-based measures of inflation compensation "have risen but remain low".

In the second paragraph, the Committee should present its decision to cut rates by 25bp. With this being already priced in, more important will be any signals it sends about its policy stance moving forward. To maintain an easing bias, this paragraph should also note that "uncertainties about this outlook remain" and repeat that "[i]n light of these uncertainties and muted inflation pressures, the Committee will continue to closely monitor the implications of incoming information for the economic outlook and will act as appropriate to sustain the expansion".

Chair Powell experienced the first dissent under his leadership at the June FOMC meeting, and we expect that this will be followed by at least one dissent at this meeting. Following his comments last Friday suggesting that he did not currently see a strong case for easier policy, Boston Fed President Rosengren is likely to dissent with a preference for keeping rates on hold. Kansas City Fed President George is also a dissent risk, though we interpreted her speech last week as being amenable to a modestly more accommodative policy stance at this point. A 50bp cut would likely have triggered more dissents and broader pushback amongst participants, which is one reason we see 25bp as a far more likely decision at this point.

Some final items to watch at 2:00pm on the day of the meeting are whether the Committee decides to tweak the interest rate it pays on excess reserves (IOER) or enact an early end to the unwind of the balance sheet. As to an IOER tweak, we think this is particularly unlikely as the highest that effective fed funds printed since the June meeting was 2.42%, well away from the 5bps from the top edge of the target range that has triggered previous tweaks.

However, with respect to the latter, we see a compelling case for ending the balance sheet unwind at this meeting, in that the Committee would not want their two policy tools to be working at cross purposes (see "Stabilizing SOMA should be step one in Fed's easing playbook"). Moreover, we read Chair Powell's comment on this topic as suggesting an early end could be expected: "if we do provide more accommodation, we'll certainly keep in mind what we said earlier this year, which is that we'll always be willing to adjust balance sheet policy so that it serves our dual mandate objectives." That said, we were surprised by the absence of discussion of this topic in the June FOMC minutes and can see an argument for not wanting to obfuscate the messaging that the balance sheet is not an active policy tool away from the zero lower bound. Ultimately, we expect the balance sheet unwind plans to remain unaltered, but it is not a high-conviction view. In the case where they do end the balance sheet unwind early, this would be accompanied by a separate addendum released alongside the standard meeting statement.

Press conference

The focus of the press conference should be on the Committee's intended message about the policy outlook for the remainder of the year. With the meeting statement focused on the July decision, the press conference – in both Powell's opening statement and his responses during the Q&A – should be where the bulk of the signaling about potential future rate adjustments takes place.

Powell is likely to reiterate that the crosscurrents that have concerned the Committee – including weak global growth momentum, trade uncertainty, and a variety of domestic and international geopolitical events – remain, inflation pressures are still muted with inflation expectations low, and that there is room to run the economy a bit hotter without stoking unwanted inflation risks. He has made clear since the June FOMC meeting that, although the G-20 meeting delayed any escalation on the trade front, persistent uncertainty continues to weigh on capex and manufacturing activity. At the same time, Powell will have to acknowledge that some incoming data have been better than expected, with little evidence of an imminent sharp slowdown in the economy. The rate cut will thus be framed as "insurance" against the potential for a more significant slowdown, which, as he noted in his June press conference, if realized would primarily hurt communities that are just now beginning to realize the benefits of a tight labor market.

The implication of this framing would be that the Committee is maintaining an easing bias in the coming months, with the onus on the crosscurrents to dissipate and data to materially improve to avoid another cut in September. However, further easing will be data dependent – which data are most important is always the key uncertainty – and occur on a meeting-by-meeting basis. In this respect, we do not expect the Committee to pre-commit to another cut in September. While we do not expect the signals from the meeting statement and press conference to intentionally nudge market pricing in a more hawkish direction – indeed, they should be reasonably comfortable with current pricing given an easing bias – this message could result in some market participants dialing back expectations of almost 70 bps of easing through year-end.

In this vein, Powell will likely have to answer questions about why the Fed is cutting rates at all given that the data have not deteriorated sharply and indeed are better than historical Fed easing episodes, including the 1995 and 1998 periods officials have highlighted. Similar to NY Fed President Williams and Vice Chair Clarida last week, he could cite the academic literature which argues that, with rates closer to zero, a swift and preemptive policy response can help to limit the damage and reduce the odds of returning to the zero lower bound in the future. In his own words from June, "an ounce of prevention is worth a pound of cure."

Powell will likely also be quizzed about what specific conditions, especially related to trade outcomes, could cause the Fed to cut or remain on hold at the next meeting in September. We expect him to preserve optionality in his response, not committing the Committee to specific actions, though he will likely reiterate that a resolution of the various uncertainties buffeting the outlook, with trade policy being a key one, could lessen downside risks and limit the need for further easing.

Remaining questions during the press conference are likely to include technical balance sheet issues (i.e., the standing repo facility), perceptions of mixed messaging from recent Fed communications, and the impact of the Trump Administration's calls for rate cuts on the Committee's decision making process. On the repo facility, the June minutes revealed that it is being actively debated, but Powell is unlikely to have a meaningful update on the timing and likelihood of such a facility at this point given how exploratory the discussions seemed in the June minutes. On the latter point, Powell should reinforce his consistent messaging that he fully intends to serve out his term, Fed independence is paramount, and policy decisions are determined by an impartial analysis of the data without influence from external forces.

Appendix 1

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