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Fed Notes

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July FOMC recap: Mid-course correction under way

- The Fed delivered on our expectation of a 25bp rate cut at the July meeting and also announced the early end to the balance sheet unwind. In the statement the Committee maintained an easing bias, and Chair Powell's press conference emphasized that, while today's decision does not mark the start of an extended easing cycle, this cut was not necessarily intended to be one and done. Indeed, his reference to past mid-cycle corrections as a model for current policy indicates that further cuts this year remain likely.
- While policy outcomes going forward will be driven by data and events, we think the bar for the Committee to remain on hold in September is relatively high. In particular, to not cut the Committee will likely need to see notable improvements on the various headwinds they have emphasized – slowing global growth and trade uncertainties – and evidence that inflation pressures are building more rapidly than anticipated. These pre-conditions are unlikely to be in place by the next FOMC meeting. Further, global headwinds are likely to persist in the months beyond, with increasing evidence of spillovers to the domestic economy. As such, we maintain our expectation for two more cuts this year in September and December.

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Statement

The July FOMC meeting statement was very close to our expectations going in. The Committee lowered the target range for the fed funds rate by 25bps to 2 to 2-1/4 percent. The statement indicated a clear easing bias for the future path of interest rates, in that it retained the language that the Committee would act as appropriate to sustain the economic expansion. It also referenced "implications of global developments" and "muted inflation pressures" as reasons to cut at this meeting, neither of which are likely to dissipate soon. The Fed also announced that it would be ending the rundown of its balance sheet in August, two months earlier than it had previously indicated, as it was clearly uncomfortable with its monetary policy tools working at cross-purposes.

With respect to the assessment of the current situation, there were not many changes from the June statement. The Committee restated its view that the US economy has solid momentum, characterizing the labor market as "strong" with economic activity "rising at a moderate rate". However, it also reaffirmed its assessment that business fixed investment growth "has been soft", a consistent source of consternation in statements from the last several meetings. We had thought that the Fed would recognize some of the uptick in market-based measures of inflation compensation. However, the FOMC demurred, maintaining that those measures "remain low", which indicates that at least the majority of the Committee is still uncomfortable with the levels of actual inflation and some measures of inflation expectations.

We had noted prior to the meeting that there was a healthy probability of hawkish dissents, especially by Boston Fed President Rosengren given his comments before the blackout period referencing the strength of the economy. He did dissent, as expected, and was also joined by Kansas City Fed President George, both advocating instead for keeping rates unchanged. We were somewhat surprised by George's dissent as we had taken her comments about demographic headwinds as evidence that she would be open to a rate cut. Her dissent potentially indicates that she may be uncomfortable with the extent of the easing bias communicated in the statement, particularly should it be based even in part on "muted inflation pressures", a concern that she has previously dismissed.

Press Conference

The most important message from the press conference was that today's cut should not be interpreted as one and done, and indeed, that the mid-1990s mid-cycle easing episodes are a good blueprint for policy today. Recall that these episodes resulted in 75bp of cuts in total. While Powell acknowledged that the outlook remained favorable, he emphasized the downside risks emanating from the various crosscurrents they have worried about, including weak global growth, trade uncertainties, and sputtering capex and manufacturing activity. Moreover, Powell reiterated the Committee's concern about "muted inflation pressures", noting "continued below-target inflation could lead to a worrisome and difficult-to-reverse downward slide in longer-term expectations."

While the market took an indication of some data dependence in further adjustments to the fed funds rate as hawkish, we think that the bar for the Committee to remain on hold in September is relatively high. In particular, to not cut the Committee will likely need to see notable improvements on the various headwinds they have emphasized – slowing global growth and trade uncertainties – and evidence that inflation pressures are building more rapidly than anticipated, all of which are unlikely to be in place by the next FOMC meeting. Powell also noted other factors that contributed to the decision to ease rates today including the Committee's downward revisions to its estimates of the neutral level of interest rates and the natural rate of unemployment.

Powell was also asked about the potential problems that could arise in the next recession stemming from the foregone policy space of today's rate cut. Powell took issue with the premise of the question, noting that after other "mid-cycle adjustments", presumably referencing 1995 and 1998, the Fed was actually able to subsequently raise rates. While this potentially muddied the message that Powell intended to send for this particular meeting statement, his point was more that such "adjustments" have the potential to put the economy on a firmer footing, perhaps warranting higher rates in the future.

Chair Powell noted that the early end to the balance sheet unwind was for the sake of maintaining "simplicity and consistency". As we flagged in June (see "Stabilizing SOMA should be step one in Fed's easing playbook"), a key reason to end the balance sheet drawdown when cutting rates is that the Fed should not want their two tools to be working at cross-purposes. This logic apparently dominated any concerns about misinterpreting the balance sheet as an active policy tool when the fed funds rate is away from the zero lower bound.

In response to a question about the reasons the Fed is cutting rates, Powell referenced that the dovish evolution from the Committee, which he noted in his prepared remarks has occurred over the course of the year, has eased financial conditions by putting downward pressure on interest rate expectations. These easier financial conditions have, in turn, kept the economy broadly on track with their expectations, albeit with lower rates. This response indicates that the Committee is aware of market pricing of further cuts and the endogeneity between Fed messaging and easy financial conditions, the latter of which are critical for offsetting the downside risks the Fed is worried about. As such, the Committee recognizes that they cannot signal a much more hawkish path than market pricing without risking tighter financial conditions.

Regarding some other topics, Powell was asked about financial risks. He noted that while there may be some elevation of asset valuations in the market and of business sector leverage, they are not at "troubling levels" and financial vulnerabilities are not unusually elevated. In a similar vein, he was also asked about macroprudential policy, noting that the high level of bank capital may afford room to cut capital requirements in the next downturn—something under consideration by the Committee. When asked about comments about monetary policy from the Administration, Powell maintained that political pressure does not enter into the Committee's decisions, neither to placate that pressure (via rate cuts) nor to prove the Fed's independence (via resisting rate cuts).

Appendix 1

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