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Fed Notes

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October FOMC preview: Looking beyond a mid-cycle adjustment

- We expect the Fed to reduce rates for the third straight meeting, lowering the target range for the fed funds rate by 25bps to 1.5-1.75%. With incoming data since the September FOMC meeting generally underperforming expectations, revisions to the statement language about recent developments should skew in a slightly dovish direction. In terms of forward guidance, the statement should retain the Committee's commitment to "act as appropriate to sustain the expansion".
- Having reached the historical threshold — 75bps of cuts — for a mid-cycle adjustment as defined by the 1990s experience that Chair Powell has often referenced, the focal point of the press conference should be the messaging about the policy path ahead. As we noted in a recent report (see " Fed messaging after the mid-cycle adjustment "), with risks still tilted to the downside, incoming data softening, and leading indicators signaling a further slowdown ahead, it is too early for the Committee to communicate the end of the cutting cycle.
- That said, the Chair could implicitly raise the bar for further cuts as they await the outcome of a few event risks related to trade policy and take time to assess incoming data. In effect, the threshold for cutting could change from not seeing an improvement in the data – which is how we interpreted the guidance from the past several meetings – to needing to see some further deterioration. This could be communicated by emphasizing the magnitude of easing to date and the long lags in monetary policy or by providing a more positive assessment of the distribution of risks around the outlook, among other possibilities.

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Meeting statement

The FOMC could make a couple of tweaks to the meeting statement that should skew slightly dovish. Recall that the Fed's median 2019 growth estimate in the September Summary of Economic Projections (SEP) increased a tenth to 2.2%, which implied back half growth of roughly 1.9% annualized. The incoming data since then have generally underperformed that expectation. While the unemployment rate has declined a couple of tenths, the three-month average for private payroll gains has fallen to 119k from 135k in August. The current three-month average is the lowest since mid-2012. In addition, recent consumer spending data, including the September retail sales report, showed slightly less momentum, and the disappointing September durable goods report pointed to further weakness in business investment.

In turn, we expect the labor market language to be downgraded slightly, with the meeting statement indicating that "Although the unemployment rate has declined, job gains have slowed." This was the language used in the June 2016 meeting statement, when payroll growth had slowed despite a drop in the unemployment rate. With respect to the other elements of the opening paragraph, the Committee will likely reiterate that "Although household spending has been rising at a strong pace, business fixed investment has weakened and exports remain soft". A risk here is that the Committee chooses to slightly downgrade consumer spending to "solid" from "strong". The inflation language should remain unchanged.

The Q3 GDP report, which will be released the morning of the FOMC meeting, could also influence the tone of the statement and press conference. Indeed, if Q3 growth is close to our long-standing estimate of 1.5%, which is notably below the Fed's 1.9% H2 growth assumption, the tone could tilt in a more dovish direction.

In the second paragraph, the Committee will present its decision to cut rates by 25bps, lowering the target range to 1-1/2% to 1-3/4%. With concerns about "global developments" and "muted inflation pressures" – for PCE inflation and inflation expectations – still driving the Committee's decision to cut rates, the rest of this paragraph should be little changed. Given the aforementioned weakness in the intermeeting data, the FOMC will want to maintain an easing bias in its language, repeating that "uncertainties about this outlook remain" and that the Fed will continue to "act as appropriate to sustain the expansion", retaining language similar to the latest speech from Vice Chair Clarida, who had the last word before the media blackout period began.

We expect that the Committee will choose not to reintroduce its assessment of monetary policy as "accommodative", which it last referenced in August 2018. Holding off on this change at this point despite the real fed funds rate being clearly below the latest median estimate of neutral after next week's cut could be justified by three factors: (1) the median view on the long-run neutral policy rate has fallen by 50bps since that time, (2) trade policy uncertainty is likely pushing estimates of short-run r-star below the long-run level, and (3) as Powell has highlighted in the past, estimates of neutral are highly uncertain.

Despite some softening in Boston Fed President Rosengren's and Kansas City President George's recent statements, they are still likely to dissent at this meeting. To be sure, should either of these two not dissent, it would send a decidedly dovish message with respect to December rate cut prospects. On the other hand, St. Louis Fed President Bullard's dovish dissent in September will likely be withdrawn with another 25bp cut at this meeting, especially given that his September fed funds forecast only indicated one more easing between now and the end of 2021.

Press conference

The focal point of the press conference is likely to be the Fed's messaging around the policy path ahead. As we noted in a recent report (see "Fed messaging after the mid-cycle adjustment"), with a 25bp rate cut at the October meeting, the Fed will have reached the historical threshold — 75bps of cuts — for a mid-cycle adjustment as defined by the 1990s experience that Chair Powell has often referenced. With risks still tilted to the downside, incoming data softening, and leading indicators signaling a further slowdown ahead, it is likely too early for the Committee to communicate the end of the cutting cycle.

However, Chair Powell could implicitly raise the bar for another cut as they await the outcome of a few event risks related to trade policy and take time to assess incoming data. In effect, the threshold for cutting could change from not seeing an improvement in the data – which is how we interpreted the guidance from the past several meetings – to needing to see some further deterioration. This could be communicated by emphasizing the magnitude of easing to date and the long lags in monetary policy or by providing a more positive assessment of the distribution of risks around the outlook, among other possibilities.

Ultimately, Powell should reiterate that uncertainties remain and that policy is not on a preset course. In this respect, the Chair would emphasize that the Committee will continue to act as appropriate to sustain the expansion, monitoring incoming data to ascertain whether further accommodation may or may not be needed.

A lesson from the 1995-96 episode was that reaching a point of nearly balanced risks was important for signaling an end to the easing cycle. Speaking at the March 1996 meeting when the Fed did not cut rates, then Chair Greenspan summarized the discussion as, "The comments around this table suggest that the members regard the risks to the economy as being as close to balance as one has seen for quite a while."

Thus, the Committee's views on evolving risks to the outlook from trade policy uncertainty and Brexit should influence how they view the policy path ahead. Powell likely will acknowledge some tentative progress on both fronts towards reducing the risks of very negative outcomes. That said, Brexit progress is now proving nettlesome, and improvement in trade tensions remains tentative with uncertainties remaining related to both auto tariffs vis-à-vis Europe and tensions with China. With several false positive signals in the past, Powell should continue to be reluctant in expressing a firm view about the likely outcome of these discussions. He should also reiterate that trade policy is generating uncertainty and acting as a headwind for the economy, particularly manufacturing and capex, which have continued to deteriorate since the September FOMC meeting.

The Chair is also likely to be quizzed about recent developments in market pricing, namely the steepening of the yield curve and continued expectations for further rate cuts. Regarding the former, Powell could note that, while it is a positive development, the steepening is very recent and thus tenuous, in addition to the fact that the yield curve slope is just one of many financial market indicators that he and the Committee track. Responses to questions about market pricing for further cuts should reiterate his points noted earlier related to policy being data dependent, determined on a meeting-by-meeting basis, and not on a pre-set course.

The Fed's recent decisions related to the balance sheet and repo operations should be discussed. In particular, Powell should be asked about his views on the appropriate level for reserves, and relatedly, when purchases aimed at rebuilding a sufficient reserve buffer could be completed. On the composition of purchases, Powell could be asked about the potential for shifting some of the announced $60bn of monthly Treasury bill purchases to short-dated coupons. NY Fed President Williams recently expressed some openness to adjusting parameters of the announced balance sheet expansion along these lines.

A final topic that is likely to appear in the press conference is the Fed's ongoing policy review. The minutes to the September FOMC meeting revealed that this discussion is progressing and that make-up strategies are being hotly debated. The minutes noted that these strategies have garnered some support, with "most participants...open to the possibility that the dual-mandate objectives of maximum employment and stable prices could be best served by strategies that deliver inflation rates that over time are, on average, equal to the Committee's longer-run objective of 2 percent." Those minutes also revealed a desire to assess the implications of inflation ranges with a midpoint above 2% – an appealing option we previously believed had been ruled out by retaining the 2% target – or where 2% acted as a floor. An update on these discussions in the press conference could therefore be informative for policy prospects in early 2020.

Appendix 1

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