Federal Reserve: We’re Cutting, But Don’t Worry

- The Federal Reserve opted to act now and ask questions later about whether the US economy really needed the quarter point reduction in policy rates that it delivered today. But the accompanying statement sounded like it came from a central bank that isn’t really sure the economy actually needs lower rates at this point. In addition to the quarter point cut, the Fed opted to cease its planned balance sheet roll down right away, as opposed to its prior plan to wait another two months.

- The accompanying statement had to lay out the reasoning behind their decision to lower rates, which centers on the softness in economies abroad and the elbow room provided by tame inflation. But the Fed opted to quickly reiterate that its base case outlook still has the economy doing well enough to sustain low unemployment and return inflation to the 2% target. In other words, don’t worry, most likely everything will be just fine and we won’t have to ease aggressively from here. Indeed, the Fed led off its text by noting that recent data have on balance looked that way, with positive news on the labor market and household spending amidst softness in business capital spending.

- Powell called this a “mid-cycle adjustment” to policy, a phrase that contrasts this move with one that marks the start of a major cyclical downturn in rates. He said that a “lengthy” easing cycle is not the Fed’s view, while he pushed back against a view that this was only a one-and-done move. But leaning on the side of a limited scope for further rate cuts ahead, there were two votes for no cut at all (George and Rosengren). In contrast, there were no formal votes for a 50 basis point move.

- The September meeting will force the issue, in that the Fed will have to present its updated outlook for the economy, as well as the “dot” projections showing the extent to which the members expect to trim rates any further. The Fed might opt to leave rates unchanged at that meeting, but if, as we expect second half growth averages near 1½%, that might be tame enough for one final further quarter point trimming in Q4 (likely October).

- Markets were pricing in a much longer series of cuts. As a result, this was a rate cut that actually will push bond yields higher today. Equities won’t like this message today, but might be happier if the Fed is right and the economy grows well enough to support gains in earnings in 2020.
• With quantitative tightening coming to an early end, the principal payments the Fed receives from Treasuries and the first $20 bn from its agency/MBS holdings will flow back into Treasuries, and any remaining agency/MBS principal payments back into MBS. The buying will match the composition of the outstanding market, so the reinvestment isn’t aimed at further tilting the yield curve slope in any particular direction. However, our fixed income strategist Ian Pollick notes that it would imply that 8% of the buying would be in TIPS (vs. only 3% during QE), which could help that segment outperform nominal bonds, particularly under our view that there isn’t really a material downside risks to inflation.

• Of course, what lies ahead, as always, will depend on the data. But the key message today is that this is a central bank that isn’t that worried about growth risks or disinflation, and is therefore not in line with the market’s prior expectation for a more significant easing cycle.

• Again, if the Fed is right about the US outlook, that’s comforting news for the Bank of Canada, but not a full all clear for the Canadian economy either. The growth rate that will sustain full employment in the US could be 2% or even a bit less, as the labor market lacks the slack needed for more rapid gains. That’s not the heady days we saw earlier in the cycle, and still a less rosy environment for Canadian exports. A further Fed cut in Q4 could still see the Bank of Canada throw in a token rate cut in 2020 if that proves necessary to push the Canadian dollar to levels more supportive for exports.