Central Banks

FOMC Meeting: June 18th-19th

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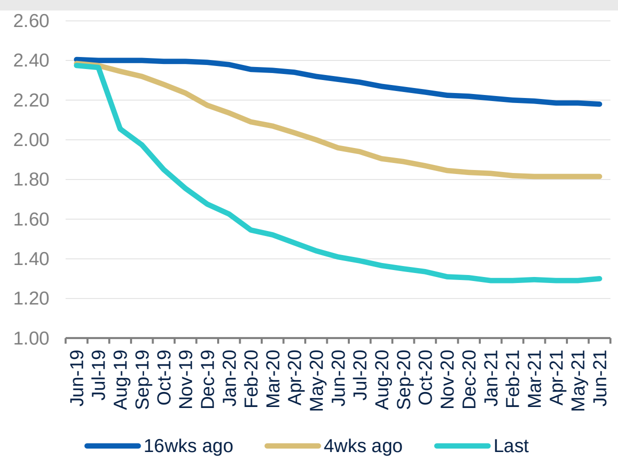
After weeks of disappointing data, rising trade tensions and renewed fears of slower global growth, the Fed set the stage for a monetary easing cycle, in line with our view. Leaving rates unchanged at today's meeting buys the Fed another six weeks' worth of additional data and allows them to realign their policy with market expectations that have trended downward in the inter-meeting period. Elevated policy uncertainty, renewed "crosscurrents" and the threat of inflation and inflation expectations further drifting below the Fed's two percent target suggest the Fed will lower rates this year. Notwithstanding an escalation in trade tensions or clear risks of a domestic economic downturn, this would likely imply a rate cut in 3Q19 and again in 4Q19. If risks materialize more quickly than anticipated, this could imply rate cuts as early as July, while a greater likelihood of an economic recession would warrant both immediate and larger reductions in the fed funds rate.

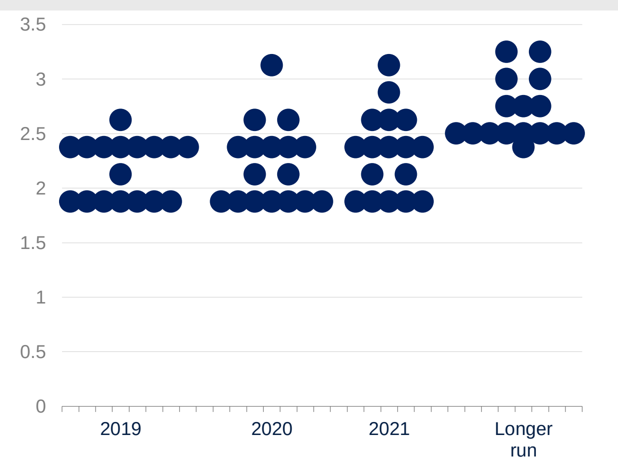
With respect to the statement, the assessment on economic conditions was mixed. Although the view of labor markets remained unchanged ("strong") and household spending was judged to have picked up rather than slowed, overall economic activity was downgraded to rising at a "moderate" rather than "solid" pace. Moreover, to the downside, uncertainties around the outlook have increased while inflation is "running below 2 percent." As a result, the shift from "patience" to "closely monitor" and the inclusion of explicit guidance on the importance of "sustain[ing] the expansion" - the largest changes on the policy side- set the stage for a potential rate cut. In fact, President Bullard provided the first dissent of Powell's chairmanship, preferring to cut rates at this meeting.

Chart 1. **Market Based Implied Fed Funds Rate** (%)



Source: Summary of Economic Projections, Federal Reserve

Chart 2. **FOMC Dot Plot** (%)



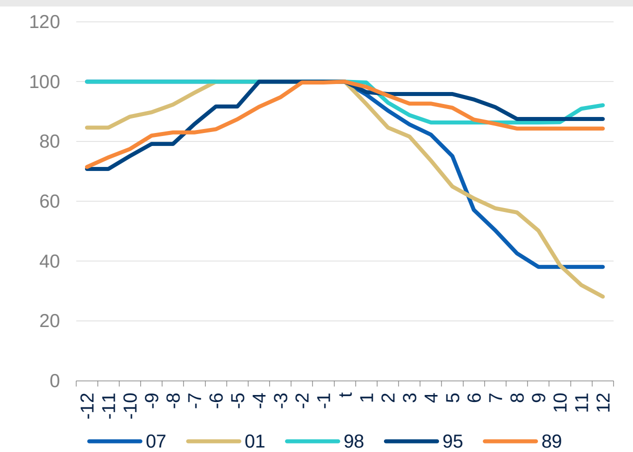
Source: Summary of Economic Projections, Federal Reserve

Surprisingly, the summary of economic projections provided little evidence of a growing bias among the committee. In fact, the median projected path of the fed funds rate was unchanged since March despite the dovish shift in the statement and weak inflation outlook. Moreover, the median view on GDP growth and the unemployment rate were little changed. That said, the range of views has diverged, with some members seeing a muted outlook for growth and inflation, as the most likely outcome. As a result, the Dot Plot hinted at a more polarized committee, with eight members viewing no rate increases as the most likely path while seven members projecting two rate cuts in 2019 as the most likely outcome.

In Powell's prepared statement, the sentiment of the committee was clear: risks to the outlook are elevated, rising and likely imply a shift in monetary policy accommodation. Powell emphasized the reemergence of "crosscurrents" and that risks to the outlook are no longer symmetric. Furthermore, there were a number of members that are doubtful that inflation will return to 2 percent in the medium term and that a further downward drift in inflation could be hard to "arrest." Moreover, even the members who viewed the most likely path of the fed funds rate as flat agreed that a cut might be needed.

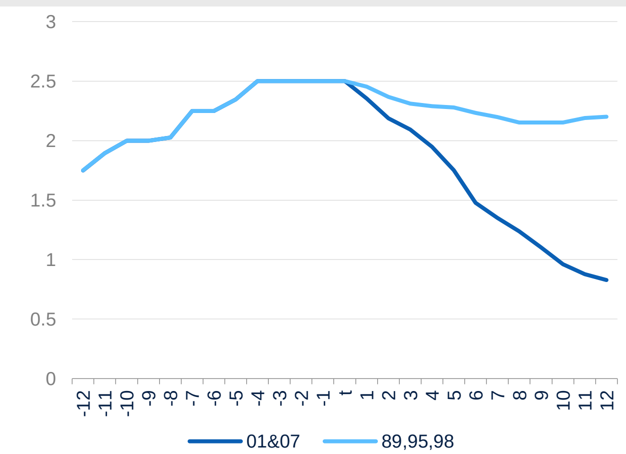
In the Q&A, Powell pushed back on the idea of cutting at today's meeting, alluding to the fact that the committee did not want to over react. Rather, the committee should be mindful of the risks while reacting to "sustained" trends. That being said, in a later exchange, he commented that an "ounce of prevention is worth a pound of cure", implying that waiting until conditions were well established to the downside is not prudent, especially when considering the implications of implementing monetary policy close to the effective lower bound (ELB). On trade, the Chairman made clear that trade policy has impacted sentiment and global growth. On the prospects of a larger than 25bp cut, the Chairman did not provide a clear answer, implying the committee has not discussed the possibilities of a larger than 25bp cut at length, and thus avoided an unwarranted market reaction.

Chart 3. **Path of Fed Funds in Past Easing Cycles** (%)



Source: Summary of Economic Projections, Federal Reserve

Chart 4. **Implied Precedent Based Path of Fed Funds*** (%)



Source: Summary of Economic Projections, Federal Reserve
*Based on timing and average magnitude of previous Fed easing cycles

Bottom line:

Today's statement reaffirms that the Fed is poised to begin an easing cycle in 3Q19, which will likely continue at least until 4Q19. Notwithstanding any shocks, the easing cycle is likely to be somewhat modest relative to recent recessionary periods, and should be enough to support the ongoing expansion. If downside risks intensify, the Fed will have to act more forcefully.

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