Central Banks

FOMC Meeting: September 17th-18th

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As we expected, the Fed lowered its benchmark interest rate by 25bp to 1.75-2.0%. Similar to the last rate cut, the changes in the stance of monetary policy were less dependent on the assessment of incoming data, as the only major change to the statement was the outlook for business fixed investment, which changed from “soft” to “weakened”, and exports which the committee also viewed to have “weakened” over the intermeeting period. The cut was again justified by the committee’s view on a “wide range of information, including measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial and international developments,” although this language was unchanged from the July statement.

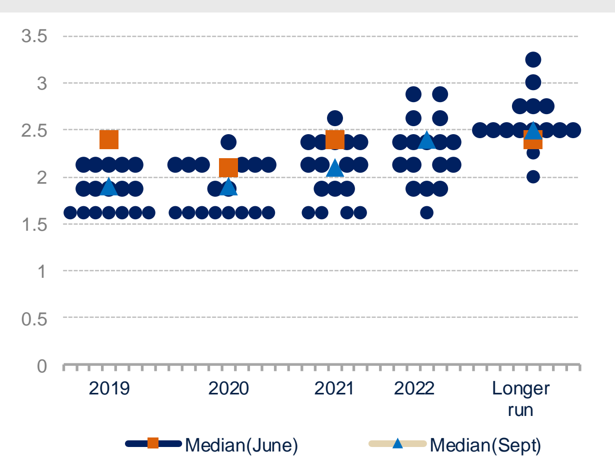
Similar to the statement, the committee’s economic projections were little changed since June despite a growing divide amongst members on the appropriate level of accommodation. In fact, GDP growth for 2019 was revised up to 2.2%, from 2.1% in June. That said, the median projection of the Fed Funds rate declined to reflect the current level of interest rates. This level is consistent with no additional cuts. However, a growing faction on the committee is coalescing around one additional cut, with seven members projecting one additional 25bp cuts in 2019 and eight in 2020. That said, five members believed that by year-end, rates would be consistent with levels prior to the September cut (2.125%).

Chart 1. **September FOMC Median Projections,** (%)

FOMC Median Estimates	2019	2020	2021	2022	Long-run
Change in real GDP	2.2	2.0	1.9	1.8	1.9
June projection	2.1	2.0	1.8		1.9
Unemployment rate	3.7	3.7	3.8	3.9	4.2
June projection	3.6	3.7	3.8		4.2
PCE inflation	1.5	1.9	2.0	2.0	2.0
June projection	1.5	1.9	2.0		2.0
Core PCE inflation	1.8	1.9	2.0	2.0	
June projection	1.8	1.9	2.0		
Federal funds rate	1.9	1.9	2.1	2.4	2.5
June projection	2.4	2.1	2.4		2.5

Source: BBVA Research & Bloomberg

Chart 2. **FOMC Dot Plot,** (end of year %)



Source: BBVA Research & Bloomberg

Unlike some of the chairman’s past press conference, today’s post-meeting Q&A was rather boilerplate with S&P ending the day up 0.1%, after declining slightly during the post-meeting press conference. Other than reaffirming the committee’s concerns over global growth, trade uncertainty and domestic inflation, the chairman did not signal any major deviation from the current course of accommodation. In fact, when asked about Federal Reserve research that suggested the impact from trade policy uncertainty could be substantial, the chairman suggested that there was a high

degree of uncertainty around those estimates. However, in a response to a later question, Powell suggested the Fed has tools to counteract the effects of trade tensions, but that the committee needed to look through the volatility of such complex negotiations in order to react appropriately for the U.S. economy. On the balance between concerns over the domestic economy and the global slowdown, once again, Powell's comments seemed to suggest that conditions abroad are weighing on the committee's decisions making.

However, the responses to questions regarding the recent surge in repo rates fell short of expectations with the chairman suggesting that the current response was sufficient and that the committee would be comfortable for some time using temporary open market operations to meet any liquidity shortfalls. In the short-term, resuming "organic" balance sheet growth and a repo facility could be needed.

Although retrospectively, there appear plausible idiosyncratic explanations for the liquidity squeeze (corporate tax payments and Treasury settlements), we anticipated that the transition to a floor system with an "abundant" supply of reserves could be volatile. There was always an implicit risk that draining reserves in the QE wind down could push reserves to a point that alters the elasticity of demand. Estimating the demand for reserve balances is difficult in normal circumstances. While bouts of intervention of this magnitude have occurred during easing cycles— 2001 and 2008— late-cycle fears, a slowing economy, a shift in the monetary policy operating framework and heightened uncertainty in the financial sector only increase the likelihood of large shortfalls in the supply of reserves, particularly if institutions begin to hoard reserves in the face of higher counterparty uncertainty and any perceived dearth of liquidity.

While neither the statement, implementation note nor the press conference committed to expand the balance sheet beyond what could be considered "organic" in order to alleviate these pressures, after Tuesday's liquidity squeeze, we now expect that the Fed will expand its asset purchase program at some point in the near future in order maintain an abundant supply of reserves. As such, in addition to reinvesting principal payments from agency and MBS securities, rolling over up to $20bn in mortgage backed securities principal into Treasuries, we now expect the Fed will buy Treasuries outright, in proportion to the distribution of outstanding Treasury debt. Given the committee's bias for fine-tuning, this most likely will occur in $5-$10bn increments until a time when the committee feels comfortable with the level of reserves in the financial system. Although the committee altered the interest paid on excess reserves and overnight reverse repurchase operations in response to the squeeze, we do not believe this will sufficiently alleviate the risk to money markets.

Bottom Line

The uncertainty around our scenario has increased with new dot-plot, threat of high-levels of trade uncertainty and because the Chairman kept the door opened to further cuts in 2019. Actual inflation data improved over the intermeeting period with core CPI reaching 2.4%. In addition, the U.S. continues to grow above potential with an unemployment rate at 3.7%. Under these conditions, it would be reasonable to assume that July and September cuts would be sufficient, and that allowing time for the economy to absorb the additional accommodation would be appropriate. However, trade uncertainty remains elevated and tensions between the U.S. and China continue. The chairman's desire to not unnecessarily leave "dry powder" in the face of growing risks also supports additional fine tuning this year. In these unprecedented circumstances, trade policy uncertainty and monetary policy will remain entangled.

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