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BREAKING NEWS
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Slow global growth compels the Fed to cut interest rates

The Federal Reserve has reduced its policy rate target for the first time since 2008. Economic data in the U.S. have been solid, but global growth is slow and a variety of policy risks hang over the outlook like dark clouds. The Fed now needs to determine whether rates need to go even lower to ward off any potential storm.

Brian Nick
Chief Investment Strategist

WHAT HAPPENED?

The Federal Reserve (Fed) heeded the market's call to lower interest rates, reducing its federal funds target rate range by 25 basis points (bps) to 2.00% to 2.25%. Futures markets had fully priced in the move after Chair Jerome Powell sounded a dovish tone in his recent public comments on Capitol Hill. The Fed, which had not cut its interest rate target since December 2008, has effectively reversed its December 2018 hike.

In addition, the Fed elected to end the drawdown of its sizable balance sheet two months earlier than initially planned. The roll off, which will now conclude on August 1, effectively drains liquidity from the financial system by allowing the Fed's holdings of securities to mature without the proceeds being reinvested. The end date for this so-called "quantitative tightening" was likely intended to align the Fed's balance sheet policy with its interest rate policy now that it has shifted from a rate-hiking cycle to a rate-cutting cycle.

The statement released after the meeting referenced "global developments," which, in addition to "muted inflation pressures," drove the Fed's decision to reduce its policy rate. The statement included a few clues about the likelihood of another rate cut in September or beyond. Notably, two Federal Reserve Bank Presidents, George and Rosengren, dissented from the decision, preferring to keep rates at the current level. Multiple dissents are unusual but not unheard of, especially at points of inflection for monetary policy.

In his post-meeting press conference, Powell suggested that the dovish shift in Fed policy and communication throughout the year, including but not limited to today's rate cut, had already provided support to the economy by lowering borrowing costs and boosting business and consumer confidence. Markets interpreted these comments and his bullish tone on the economy to indicate a somewhat lower likelihood of further rate cuts.

WHY IS THE FED CUTTING RATES?

The U.S. Congress gives the Fed two mandates: price stability and maximum employment. Currently, U.S. inflation is stable, though somewhat below the Fed's 2% target. U.S. unemployment was 3.7% in

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June, close to a 60-year low and well below the Fed's estimate of the longer-run jobless rate. With both mandates largely fulfilled, why did the Fed feel it needed to ease policy?

Powell and his colleagues have frequently cited slow global growth and policy uncertainty as the main sources of downside risk to their outlook. Growth has slowed outside the U.S. over the past several quarters, most notably in China and the eurozone. And policy uncertainty, whether related to trade, Brexit or U.S. budget negotiations, has certainly clouded the outlook. The Fed feels that cutting interest rates is a low-cost insurance policy against any worsening of conditions down the road. It does not believe that rate cuts are needed today to keep the expansion going.

IS THIS JUST THE BEGINNING?

Investors' attention now turns to the September FOMC meeting, when the committee will release new forecasts, including an updated "dot plot" of its expected path for interest rates. At the June meeting, no member believed the Fed would need to reduce the target rate range by more than 50 bps in 2019 or beyond. That view does not square with the fed funds futures market, which prior to the meeting had priced in a 65% chance that the Fed would reduce rates four times or more by the end of 2020.

Despite Powell's upbeat press conference, we think there is still a better than 50-50 chance that the Fed will cut again at the next meeting. The odds of a September cut fell to 54% in futures pricing from 73% before the meeting. Whether the Fed reduces rates again in September, we do not believe it will ultimately go as low over the next several quarters as the markets currently expect.

This sets up an interesting Catch-22 for markets over the remainder of the year. Longer-term interest rates have fallen and S&P 500 Index valuations have risen in 2019, in part because of expectations that the Fed would cut rates as it did today. But if the Fed ultimately stops short of market expectations, it could jeopardize the rallies in both stocks and bonds. We saw a simultaneous mild rise in short-term interest rates and fall in major equity indexes in the minutes after the statement was released today.

Ultimately, we view the risks to global markets from a Fed disappointment as relatively minor. If global economic data improves by October and the U.S. has not erected any new import taxes, both the Fed and the markets should feel comfortable with interest rates at their current levels. Any dip in stock prices would likely be short-lived and shallow, as long as underlying economic data supports earnings growth. And we do not expect a meaningful rise in long-term U.S. bond yields while other developed market interest rates remain mired in negative territory.

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Endnotes

Sources

Federal Reserve Statement, July 2019.

Bloomberg.

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Glossary

A **basis point** is a common unit of measure for interest rates and other percentages in finance. One basis point is equal to 1/100th of 1%, or 0.01%.

The **core PCE price index** is defined as personal consumption expenditures (PCE) prices excluding food and energy prices.

The **Federal Open Market Committee (FOMC)** holds eight regularly scheduled meetings per year to review economic and financial conditions, determine the appropriate stance of monetary policy and assess the risks to its long-run goals of price stability and sustainable economic growth.

S&P 500® Index is a capitalization-weighted index of 500 stocks designed to measure the performance of the broad domestic economy.

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