Waiting for a rate cut: How much is too much?

Weekly Market Compass: Some want the Federal Reserve to cut 50 basis points, but I believe 25 basis points is a better target

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There is a famous Rolling Stones song that provides sage advice for demanding toddlers and spoiled teenagers – and perhaps financial markets: "You can't always get what you want. But if you try sometimes, well you might find, you get what you need." That refrain is stuck in my head as I anticipate this month's Federal Reserve (Fed) meeting. A cut is widely expected – but what is the level that markets need, versus what they want?

Investors want the Fed to cut rates in July – some have even called for a cut of 50 basis points (bps). Enthusiasm for that number has intensified since Fed Chair Jay Powell's appearance before Congress last week, when he received a question about whether a 50 bps rate cut was possible. He didn't answer the question, which revived the possibility that it could happen.

I caution against expecting a 50 bps rate cut; I believe that would actually be cause for alarm. In my view, such a move is more appropriate for an economy that is not as healthy as the current US economy, with greater downside risks. But, I believe there are some compelling reasons for the Fed to cut rates 25 bps in July:

- **Economic risks.** The risks to the economy are increasing. The minutes from the June Federal Open Market Committee (FOMC) meeting, which were released last week, provide a more negative assessment of the economic outlook than the minutes from previous meetings. Downside risks were characterized as having "increased significantly" with "many" participants worried about their increasing probability.[1]
- **Trade wars.** In particular, growing trade conflicts pose a significant risk to the global economy. In his testimony last week, Powell said that the risks from the US-China trade war hang over an otherwise healthy market, explaining that since Fed officials met last month, "uncertainties around trade tensions and concerns about the strength of the global economy continue to weigh on the US economic outlook."[2] The FOMC minutes indicate particular concern about decreased business investment (as we know, decreased business investment often occurs as a result of economic policy uncertainty). This was reiterated last Friday, when I attended a speech by Chicago Fed President Charles Evans, who said business investment has been lower than he would have expected given tax reform stimulus. It is clear that the trade wars are already doing damage – in decreased business investment and in global manufacturing indicators – and the Fed is worried the situation could worsen. Last week, St. Louis Fed President James Bullard argued that the Fed should cut rates in July as "insurance" against trade-related lower growth.[3]
- **The "neutral rate."** Powell also testified that the "neutral rate" – the rate at which monetary policy is neither expansionary or contractionary – is lower than past estimates suggested,[4] which opens the door to the Fed cutting rates without any change in economic data.
- **Low inflation.** Last week, Evans talked during his speech about the importance of pushing inflation higher. He said that it has been too low for too long, and said that the Fed should be committed to reaching its inflation target in order to maintain credibility. Powell also is interested in boosting inflation. He said there has been a breakdown in the Phillips Curve relationship between inflation and unemployment – even though unemployment has been low, it hasn't impacted inflation. "The relationship between unemployment and inflation became weak" about 20 years ago, Powell said, and "it's become weaker and weaker and weaker."[4] This suggests the Fed could even raise the inflation target, which would also allow the Fed to cut rates without any change in economic data.

- **The job market.** A strong jobs market may not deter the Fed from cutting rates. Powell went so far as to say that he does not think the job market is strong: "We don't have any basis or any evidence for calling this a hot labor market."[5]

- **A focus on prevention.** It's clear that the FOMC is interested in preemptively fighting what could be an "adverse shock." Powell reiterated a theme he has advocated before: An ounce of prevention is worth a pound of cure. Powell said the US economy is "in a very good place," but that it's important to use monetary policy tools "to keep it there" and offset any weakness stemming from a global slump in manufacturing and business confidence linked to trade tensions.

Conclusion: I expect a 25 basis point cut

Finally, there may be another reason for the Fed to cut rates. Last week, the US Treasury Department released updated deficit statistics. The deficit is growing like a weed: For the first nine months of fiscal year 2019, the deficit is 23% larger than in the same period in fiscal year 2018.[6] One factor amplifying the deficit is the rising cost to service the debt: Interest expense rose 16.4% from the previous year, largely reflecting the rise in interest rates.[7] While the Fed has never mentioned rising debt service costs as a reason to cut rates, as US government debt continues to balloon, lowering rates would ease some pressure.

With regard to the possibility of a 50 bps rate cut, I don't expect it to happen – and I don't think it should happen. In fact, I'd rather see a 12.5 bps rate cut rather than a 50 bps rate cut. (While that might sound crazy, former Fed Vice Chair Stanley Fischer, who was also governor of the Bank of Israel, was rumored to have argued for a 12.5 bps move for the first Fed rate hike back in 2015, in order to ease the markets into tightening.)

In my view, a 50 bps rate cut would – and should – cause alarm. I believe the Fed should err on the side of moderation, especially since it has been characterizing this potential move as preventative; it certainly has several more meetings this year – each with its own press conference afterward – in which it can lower rates. And don't forget that the Fed has another important consideration: maintaining enough dry powder for the next crisis. With the fed funds rate so low and the Fed's balance sheet so bloated, the Fed does not have the arsenal it had a decade ago when it sought to combat the global financial crisis.

To me, all signs point to the Fed cutting its benchmark rate by 25 bps when it meets at the end of July – that's giving investors what they need, even if it's not necessarily what they might want. Having said that, we can't underestimate the threat that trade wars pose as they continue and intensify, so I believe the Fed would be right to act in July, and then follow the situation closely to see if more accommodation is needed down the line.

Source

[1]Federal Open Market Committee, June meeting minutes

[2]US Federal Reserve, statement by Jerome H. Powell before the Committee on Financial Services, July 10, 2019

[3]Reuters, "Fed's Bullard, citing low inflation and trade, calls for rate cut," July 10, 2019

[4]Bloomberg, L.P., "Powell says Fed has room to cut, may have kept policy too tight," July 11, 2019

[5]CBS News, "Fed's Powell says 'hot' labor market is overhyped," July 10, 2019

[6]The Wall Street Journal, "US budget gap widened 23% in first nine months of fiscal year," July 11, 2019

[7]US Treasury, Monthly Treasury Statement, as of June 30, 2019

Important information

A basis point is one hundredth of a percentage point.

The Phillips Curve is the theory that inflation and unemployment have an inverse relationship.

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