FOMC Statement & Potential Impact on Fixed Income

Global Fixed Income, Currency & Commodities

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IN BRIEF

- The Federal Open Market Committee (FOMC) cut the Fed Funds rate target range by 25 bps to 2.00%-2.25%. The news was met with some disappointment, as the market thought core members of the FOMC would advocate for more aggressive action (a view we shared). The post-announcement and more notably the reaction to Federal Reserve (Fed) Chairman Jerome Powell's press conference moved equities lower, reduced inflation expectations and the U.S. Treasury yield curve flatter. The market reaction indicated that the decision to cut 25 bps was underwhelming despite a commitment to do more if needed and an early end to the balance sheet reduction.
- Outside of the rate cut and the early end to the balance sheet, the July FOMC statement maintained most of the language used in the June statement such as the comment that the Fed will act as necessary in order to sustain the expansion. While the Committee still expects a strong labor market and 2% inflation are the most likely outcomes, the statement maintained mentions of uncertainties in conjunction with muted inflation pressures as reasons to closely monitor the data.
- There were two dissenters at the meeting, Esther George and Eric Rosengren both preferring to keep interest rates unchanged.

Committee Statement

We can break the statement into two parts:

- Economic Assessment—The Committee modestly adjusted its current assessment in order to reflect recent data released on the labor market and U.S. economic activity. While household spending picked up, business investment remained soft. On inflation, the Committee characterizes inflation expectations as having declined according to market-based measures. Realized inflation remains low with both headline and core inflation below the 2% target.
- Outlook—The Committee maintained the following statement that they will "continue to monitor" incoming information given remaining uncertainties and muted inflation pressure. While the Committee continues to expect the most likely outcome to be sustained growth accompanied by a strong labor market and inflation matching their objective, they maintained language in the statement to reinforce the fact that the Committee is willing to take action and adjust policy in order to sustain the expansion.

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Chair's Press Conference

Chair Powell spent the majority of his time explaining the Committee's rationale for easing monetary policy. He highlighted the weak global growth backdrop and soft U.S. manufacturing sector in contrast to the continued strength in the labor market. On the inflation side, Chair Powell continued to express concerns around inflation remaining below the Fed's 2% personal consumption expenditures target and the risks that inflation expectations could slide lower and become unanchored.

The crux of Chair Powell's case for easing was centered on the desire to take incremental steps to ease policy in the face of heightened uncertainty and protect against downside risks of weak global growth and muted inflation.

The Chair was challenged by a number of questions including if 25 bps was sufficient to address the FOMC's concerns and if this rate cut was part of an easing cycle or a just a one-time adjustment. His responses oscillated around concepts of a "mid-cycle rate cut" or an "easing cycle". Overall, the Chair struggled to communicate the Committee's thinking on the policy actions today and especially on the path going forward. This was in sharp contrast to comments made by the Chair and Vice-Chair as recently as two weeks ago.

Our View

- We expect the Fed to cut policy rates two additional times in 2019 in order to address the downside risks to U.S. growth, rising trade tensions and a slowing U.S. manufacturing sector with risks to business investment. We view 1.75-2.25% as the range for the 10-year Treasury yields under this environment in which trade risks remain elevated and the Fed responds to slowing industrial production.
- In today's meeting, the Committee signaled their willingness to act preemptively although the Chair's press conference performance adds uncertainty to the extent to which the Fed will act aggressively.
- The case for the Fed to continue to ease policy further is bolstered by low inflation that is below the Fed's 2% target. The Fed is also conducting a monetary policy review this year in which they appear to be considering a modification to their inflation strategy in order to better achieve their inflation objective and avoid a downward drift in inflation expectations. Although a formal change is not imminent in the next few months, the trend of Fed speakers indicates the Committee is leaning towards some type of change that would encourage more inflation and could result in an average inflation target—which would incorporate past misses in inflation more explicitly. The result would mean easier policy for longer unless realized inflation rises more materially and could also mean additional rate cuts would be justified if inflation is weakening along with softening growth prospects.
- We were disappointed in the Chair's press conference and felt that the message was inconsistent with previous communication, causing more undo volatility than was expected. We expect other members will be speaking publicly to re-anchor investors' expectations around the policy response given their objective to extend the cycle for as long as possible. Looking beyond the disappointing press conference, we believe the FOMC is employing a proactive risk management approach as opposed to a reactionary policy. It remains to be seen if the risk managed approach can offset the potential negative outcomes that have thus far been associated with the U.S.-China Trade policy/uncertainty.
- The Fed fully closed the book on balance sheet normalization which is set to end two months early, in August.