JUNE FOMC MINUTES AND CHAIR POWELL’S TESTIMONY POINT TOWARD JULY RATE CUT

The minutes to the June 18-19 FOMC meeting detailed the reasons underlying the dovish changes to the Official Policy Statement, the FOMC’s significantly lower projections for the appropriate path of the Federal funds rate, and the downward revisions to forecasts for inflation through 2020. The minutes and Fed Chair Powell’s testimony before Congress indicate that although the Fed’s baseline outlook is for sustained solid U.S. economic and job growth, the Committee is very concerned about the slowdown in global growth, policy-related uncertainties (especially trade), gloomy business sentiment, and the risk of persistently weak inflation below its 2% target.

The Fed’s communications over the last month support our expectation for a 25bp reduction in the Fed funds rate at the July 30-31 FOMC meeting (“Fed to lose “patience” and cut rates this year”, June 6, 2019). We doubt that Fed funds rate cuts will actually stimulate real GDP growth and/or boost inflation above the Fed’s 2% target. With bond yields and the costs of capital already close to historical lows and the yield curve mildly inverted, actual stimulus seems unlikely. Easing may boost financial markets, but not likely expectations in the real economy (“More monetary easing: no economic impacts and mounting costs and risks, so why do it?”, June 26, 2019).

The minutes presented several reasons from Fed members describing the potential need for additional policy accommodation in the near term:

1) “Several participants noted that a near-term cut in the target range for the federal funds rate could help cushion the effects of possible future adverse shocks to the economy and, hence, was appropriate policy from a risk-management perspective.”

2) “Some participants also noted that the continued shortfall in inflation risked a softening of inflation expectations that could slow the sustained return of inflation to the Committee’s 2 percent objective.”

3) “Several participants pointed out that they had revised down their estimates of the longer-run normal rate of unemployment and, as a result, saw a smaller upward contribution to inflation pressures from tight resource utilization than they had earlier.”

4) “A few participants were concerned that inflation expectations had already moved below levels consistent with the Committee’s symmetric 2 percent objective and that it was important to provide additional accommodation in the near term to bolster inflation expectations.”

5) “A few participants judged that allowing inflation to run above 2 percent for some time could help strengthen the credibility of the Committee’s commitment to its symmetric 2 percent inflation objective.”

Fed members forecast that real GDP growth will slow towards their estimates of longer-run potential (1.9%) this year, but their perceived potential downside risks have risen materially since the May FOMC meeting, far outweighing the upside risks. Downside risks mentioned in the minutes included: 1) the continued trade negotiations; 2) slower global growth; 3) sharp reduction in U.S. government spending at the end of this fiscal year unless Congress reaches a budget agreement; 4) extended negotiations about raising the debt limit; and 5) sharp economic slowdown that is exacerbated by heavy debt burdens at many U.S. firms. The only upside risk cited was: 1) a successful resolution of trade tensions and sharp rebound in business sentiment.

Reflecting the Fed’s updated assessment in its June Official Policy Statement that

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“uncertainties about this outlook have increased,” a large increase in FOMC members characterized risks as decidedly to the downside: 14 members described risks to real GDP growth as weighted to the downside, compared to four previously (Chart 1), and six members characterized uncertainties about their real GDP forecasts as higher in the June Summary of Economic Projections (SEPs), double the three members in March.

The minutes suggested that many participants viewed additional policy accommodation as warranted in the near term if uncertainties persisted. Fed Chair Powell emphasized the persistence of these uncertainties in today’s prepared testimony before the House of Representatives’ Committee on Financial Services, essentially locking in a rate cut at the upcoming July FOMC meeting:

“Since then [the June FOMC meeting], based on incoming data and other developments, it appears that uncertainties around trade tensions and concerns about the strength of the global economy continue to weigh on the U.S. economic outlook. Inflation pressures remain muted.”

Fed Chair Powell also said, in response to a question, that the solid June Employment Report did not change the outlook for whether a reduction in interest rates is appropriate in the near term because of these lingering global and trade uncertainties.

The FOMC revised down its forecasts of inflation in 2019-2020 and nine Fed members believe the risks to headline PCE inflation forecasts are tilted to the downside, up from three members from the March SEPs. (Chart 2). This tilt in expectations toward further disinflation reflected the drift down in actual inflation and global disinflationary pressures. Many members expressed concerns that longer-run inflation expectations could be below 2%. Still, several participants continue to expect inflation to climb to the 2% target because trimmed mean measures of inflation remain around 2% (excludes the influence of components with unusually large changes in prices).

The Fed senses a delinking of the unemployment rate and changes in wages and inflation. Chair Powell, before Congress today, noted that despite the sustained robust labor market performance in recent years, he does not view the labor market as “hot.” Although the unemployment rate has been very low, nominal wage gains have been moderate.

The Fed minutes mentioned the UST yield curve (10yr minus 3mth) that has been inverted for almost two consecutive months and the associated increased risk of a slowing in the economic expansion. Still, we note that U.S. financial conditions are supportive of economic growth and provide potential upside risks: 1) long-run interest rates and mortgage rates are very low; 2) the S&P 500 is near all-time highs; and 3) corporate credit spreads have tightened.

Figure 1: FOMC’s participants’ assessments of uncertainty and risks around their GDP projections

Source: Federal Reserve
Figure 2: FOMC's participants' assessments of uncertainty and risks around their headline PCE inflation projections

Source: Federal Reserve
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