First Trust
Monday Morning OUTLOOK

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Don't Count on a Rate Cut

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At the close of activity on Friday the futures market in federal funds was projecting a 75% chance of at least one rate cut this year. From now through the end of 2020, the market is projecting two rate cuts.

We thought markets stopped believing in Santa Claus a long time ago, but unfortunately it doesn't appear so.

The US economy is nowhere even close to needing one rate cut much less two. Nominal GDP – real GDP plus inflation – was up at a 3.8% annual rate in the first quarter, is up 5.1% from a year ago, and is up at a 4.8% annual rate in the past two years, all well above the federal funds rate of 2.375%.

Yes, the yield on the 2-year Treasury security is only 2.21% – meaning the very short end of the yield curve is inverted – but that's because many investors anticipate rate cuts. Hypothetically, if the Federal Reserve were to cut rates once this December and once in December 2020, then the average federal funds rate over the next two years would be very close to 2.1%, which is what's holding down the 2-year yield in the first place.

But we don't think the Fed is anywhere close to cutting rates, as we suspect the minutes from the last meeting (on April 30 and May 1) will show. Those minutes will be released this Wednesday, two days from now.

The last time the Fed issued one of its "dot plots" was on March 20. At the time, there were six Fed policymakers who thought the Fed would raise rates at least once later this year, while eleven thought the Fed would remain steady. As far as 2020 was concerned, not one policymaker saw rates lower at the end of that year than they are today.

Think of the environment in which the Fed made those projections. The S&P 500 was lower than the Friday close while the 10-year Treasury yield was higher. In other words, some analysts at the Fed should be thinking that current financial conditions are already more accommodative than they were on March 20.

It's also important to recognize that on March 20 the Atlanta Fed's GDP model was projecting a 0.6% real GDP growth rate for the first quarter while the New York Fed's model was forecasting a growth rate of 1.4%. As it turns out, real GDP grew at a 3.2% annual rate in Q1, although this figure may be revised down slightly next week.

In spite of all this, some on the Fed seem to be listening to the White House and are angling for a looser stance for monetary policy in the future. This includes Minneapolis Fed Chief Neel Kashkari and Fed Governor Lael Brainard, both of whom seem comfortable with letting measured inflation run consistently above 2.0% for several years.

We think that would be ill-advised but might end up happening anyhow. Monetary policy has been loose for a long time and, given the lags between Fed policy and inflation, will most likely result in inflation exceeding the Fed's 2% target.

To us, it looks increasingly likely that the Fed isn't going to raise rates this year. However, we do expect that tight labor markets, rising wages, continued 3% real GDP growth and a boost in inflation will increase pressure for a rate hike and change the mind of any Fed doves. If the Fed hasn't lifted rates by mid-year 2020, then don't expect one until December. The Fed has meetings scheduled for November 4-5th, 2020, right after the presidential election, and then mid December 2020. Raising rates days after the election would make the Fed appear very political.

We think that's unfortunate because the economy could easily withstand a rate hike, and such a move would help stabilize the economy over the longer term by preventing an upward move in inflation in the future.

In the meantime, postponing short-term rate hikes probably means longer term interest rates stay relatively low, as well. While we think this is a mistake, low long-term rates are a positive for equities in the meantime.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
5-21 / 9:00 am	Existing Home Sales – Apr	5.350 Mil	**5.310 Mil**		5.210 Mil
5-23 / 7:30 am	Initial Claims May 18	215K	**217K**		212K
9:00 am	New Home Sales – Apr	0.675 Mil	**0.647 Mil**		0.692 Mil
5-24 / 7:30 am	Durable Goods – Apr	-2.0%	**-2.9%**		+2.6%
7:30 am	Durable Goods (Ex-Trans) – Apr	+0.1%	**-0.1%**		+0.3%