First Trust
ECONOMIC RESEARCH REPORT
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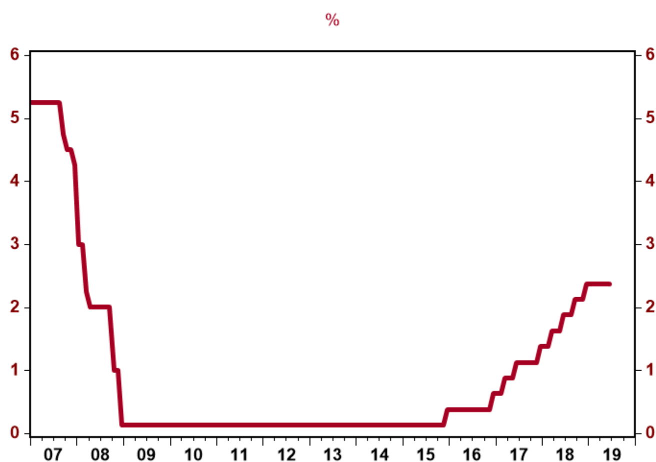
Fed Tees Up Rate Cuts

The Fed got as dovish as it could get today without actually cutting short-term rates.

The Fed's next meeting is at the end of July. If by that time the Trump Administration has made noticeable progress on a trade deal with China (without backsliding on other trade relationships) ***and*** inflation has picked up relative to the Fed's expectations, then a rate cut might not happen; otherwise a rate cut is more likely than not in July.

Right now, the futures market in federal funds puts a stunning 100% likelihood on a July rate cut. We think that's too high, but a 70% likelihood seems about right. The reason a rate cut is now more likely than not is that the Fed is focused on bringing its preferred measure of inflation – the deflator for personal consumption expenditures (PCE) – back up to an *average* of 2.0% versus the current level of 1.5%.



The Fed made an important change to its economic forecast. It's now projecting a 1.5% increase in PCE prices this year versus 1.8% back in March. PCE prices are expected to grow 1.9% in 2020 versus a March forecast of 2.0%. Notably, it's not showing any year with inflation above 2.0%.

The reason that's significant is that the Fed describes its 2.0% inflation goal as "symmetric," which means it wants to see an average pace of 2.0% inflation over time, with periods of inflation below 2.0% (like we're in now) offset by periods when inflation runs above 2.0%. The goal of averaging 2.0% inflation means the Fed has given itself room to cut rates based on inflation data alone, *even if the US strikes a deal with China*.

Superficially, the Fed's "dot plots" suggest no rate cut this year, but that projection dangles by a thread. Of the seventeen Fed policymakers who made projections, one showed a 25 basis point rate hike and eight showed no change at all. In other words, the shift of even one more official toward rate cuts would have made a rate cut the median outlook. Eight policymakers already project a rate cut, with seven of them showing 50 bps in cuts by year end. Notably, the median forecast for the federal funds rate at the end of 2020 is now 2.125% versus a prior estimate of 2.625%. The median projection for the longer-run average rate is now 2.50% versus a prior estimate of 2.75%.

The Fed's statement was dovish, as well. Economic growth was downgraded from "solid" to "moderate" and they noted a decline in "market-based measures of inflation compensation." Later in the statement, the Fed wrote that "uncertainties…have increased" and that it will "closely monitor" incoming information and "will act as appropriate to sustain the expansion, with a strong labor market and inflation near its symmetric 2 percent (inflation) objective." The reference in prior statements to being "patient" about deciding on changes to short-term rates was taken out back, shot, and quickly buried in an unmarked grave. The last key point from today's meeting is that one policymaker, James Bullard from the St. Louis Fed, dissented, voting in favor of a 25 bp rate cut at today's meeting.

The bottom line is that regardless of the likelihood of the Fed cutting rates, we think rate cuts are unnecessary. Nominal GDP – real GDP growth plus inflation – is up 4.8% in the past two years, which suggest the Fed should be raising rates rather than cutting them.

Nevertheless, as we stated above, it now looks like the Fed has positioned itself to cut rates in July unless the US reaches a trade deal with China and inflation turns up faster than the Fed now expects. While the futures market suggests a July rate cut would be 25 bp, we think that if the Fed does cut in July, there is a significant chance that it could be a one and done of 50, or even 75 bps. Cutting a small amount when the market expects further rate cuts later on creates an incentive for households and businesses to postpone activity. So, instead, if a rate cut happens, chances are it will be larger than the market now expects.

The current environment is very bullish for equities, which would be cheap even without rate cuts. In the meantime, holders of long-term bonds may come to regret policies that mean a faster pace of inflation over the long run.

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Text of the Federal Reserve's Statement:

Information received since the Federal Open Market Committee met in May indicates that the labor market remains strong and that economic activity is rising at a moderate rate. Job gains have been solid, on average, in recent months, and the unemployment rate has remained low. Although growth of household spending appears to have picked up from earlier in the year, indicators of business fixed investment have been soft. On a 12-month basis, overall inflation and inflation for items other than food and energy are running below 2 percent. Market-based measures of inflation compensation have declined; survey-based measures of longer-term inflation expectations are little changed.

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. In support of these goals, the Committee decided to maintain the target range for the federal funds rate at 2-1/4 to 2-1/2 percent. The Committee continues to view sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective as the most likely outcomes, but uncertainties about this outlook have increased. In light of these uncertainties and muted inflation pressures, the Committee will closely monitor the implications of incoming information for the economic outlook and will act as appropriate to sustain the expansion, with a strong labor market and inflation near its symmetric 2 percent objective.

In determining the timing and size of future adjustments to the target range for the federal funds rate, the Committee will assess realized and expected economic conditions relative to its maximum employment objective and its symmetric 2 percent inflation objective. This assessment will take into account a wide range of information, including measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial and international developments.

Voting for the monetary policy action were Jerome H. Powell, Chair; John C. Williams, Vice Chair; Michelle W. Bowman; Lael Brainard; Richard H. Clarida; Charles L. Evans; Esther L. George; Randal K. Quarles; and Eric S. Rosengren. Voting against the action was James Bullard, who preferred at this meeting to lower the target range for the federal funds rate by 25 basis points.

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