First Trust
ECONOMIC RESEARCH REPORT
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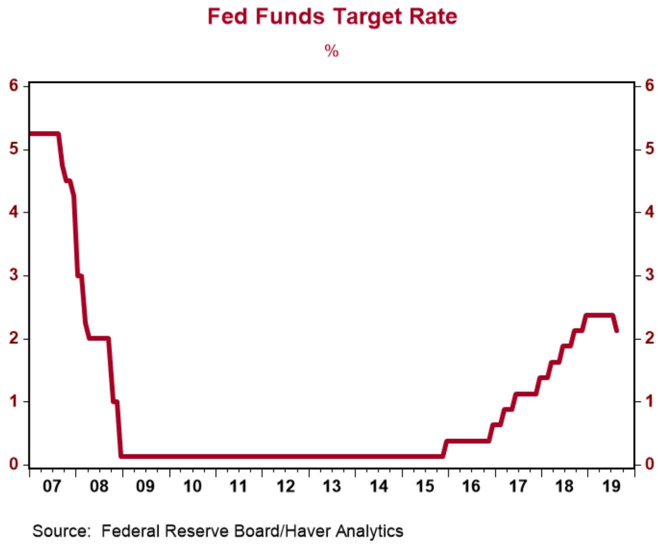
Drip Drip Drip

The Fed cut short-term interest rates by 25 basis points today, moving the range for the federal funds rate down to 2.00 - 2.25%. It also announced it will stop reducing its balance sheet in August, two months earlier than previously planned.

It made these moves despite better-than-expected economic data since the last meeting in June, as well as Chairman Powell's assessment at the press conference that our economic performance is "reasonably good" and the outlook is "good," as well. The Federal Reserve still claims it's "data dependent," but no one should believe it.



We don't think today's rate cut was needed, and would prefer that they continue to shrink the balance sheet. Nominal GDP is up 4.0% in the past year, and is up at a 5.0% annual rate in the past two years. Both figures stand well above the Federal Reserve's target for short-term rates. On policy, we agree with Esther George and Eric Rosengren, bank presidents for Kansas City and Boston, respectively, who dissented stating they preferred no change in rates at today's meeting.

We think cutting rates by 25 basis points was the <u>worst</u> possible policy outcome. If the Fed was determined to cut rates, it should have committed further – by 50 basis points or more – to tell businesses and consumers considering big-ticket purchases the Fed is planning for one-and-done. By cutting rates only 25 basis points and leaving alive expectations of further gradual cuts at coming meetings – drip, drip, drip – the Fed has created an incentive to postpone economic activity. Powell said the Fed wasn't committed to a series of rate cuts, but didn't give markets a reason to believe it. After all, at the June meeting the median interest rate projection from the Fed was for rates to remain unchanged through year-end.

The Fed's statement justified the rate cut based on "global developments" and "muted inflation." At the press conference, Powell referred to the European Union and China as points of global concern. But US monetary policy is not the tool to address these problems. Powell also suggested the Fed is concerned with a "downward slide" into lower inflation expectations. It is true that the Fed's favorite inflation measure, the PCE deflator, is up only 1.4% from a year ago. However, it's up at a 2.2% annual rate in the past three months. This is not an environment where deflation seems like much of a risk.

Putting aside whether the Fed is doing the right thing, we think the Fed is likely to reduce rates by another 25 basis points in September. In for a penny, in for a pound. The current environment remains bullish for equities, which were cheap even without rate cuts. In the meantime, holders of long-term bonds will eventually 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 June indicates that the labor market remains strong and that economic activity has been 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 has picked up from earlier in the year, growth of business fixed investment has 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 remain low; 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 light of the implications of global developments for the economic outlook as well as muted inflation pressures, the Committee decided to lower the target range for the federal funds rate to 2 to 2-1/4 percent. This action supports the Committee's view that sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective are the most likely outcomes, but uncertainties about this outlook remain. As the Committee contemplates the future path of the target range for the federal funds rate, it will continue to 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.

The Committee will conclude the reduction of its aggregate securities holdings in the System Open Market Account in August, two months earlier than previously indicated.

Voting for the monetary policy action were Jerome H. Powell, Chair; John C. Williams, Vice Chair; Michelle W. Bowman; Lael Brainard; James Bullard; Richard H. Clarida; Charles L. Evans; and Randal K. Quarles. Voting against the action were Esther L. George and Eric S. Rosengren, who preferred at this meeting to maintain the target range for the federal funds rate at 2-1/4 to 2-1/2 percent.