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How Much "Insurance" Does Latest Rate Cut Buy?

After the FOMC cut rates, Fed Chair Powell said nope to NIRP (negative interest rate policy). But a return to ZIRP (zero interest rate policy) and more QE/forward guidance seem inevitable.

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As expected, the Federal Open Market Committee (FOMC) reduced its target funds rate by 25 basis points (bps) to a new 1.75-2% range. The vote for the action included three dissents—two in favor of no rate cut and one that favored a larger reduction of 50 bps. The statement that accompanied this action was nearly identical to the July statement with a slight upgrade to the FOMC's assessment of the consumer and household spending while simultaneously downgrading its assessment of business capital investment and exports. The inflation backdrop language was unchanged.

This meeting also included the FOMC's quarterly update to its summary of economic projections (SEP) and the infamous "dot plot" that depicts each participant's outlook regarding the future path of the Fed's policy rate. The SEP changes were minimal, with a minor upgrade to the central tendency forecast for growth in 2019 (2.2%), but no change to the 2020 outlook (2%). As it relates to inflation, the SEP made no change to the 2019 expectation for the core personal consumption expenditures deflator (1.75%) and a small (0.1%) downgrade to the 2020 expectation (1.95%).

The median that falls out of the FOMC "dot plot" typically receives considerably more market attention than the SEP and the details behind the current iteration informs us of a very divided central bank. For 2019 and 2020, the median "dot" is 1.875%, which matches the midpoint of the new target range set at its September 18 meeting. In other words, the median "dot" foresees no change in the FOMC target rate through the end of 2020. The details behind that median depicts the divide of the committee, with eight participants anticipating one additional rate cut, two calling for no change, six calling for one rate hike, and one anticipating two rate hikes (all through the end of 2020).

Sustaining the Expansion Amid Ongoing Uncertainty
During the Sept. 18 press conference, Chair Powell reiterated that the FOMC will act as appropriate to sustain the expansion. He was careful to avoid characterizing the FOMC's action as a mid-cycle adjustment/insurance cut. This was something he did at July's press conference and it caused considerable angst for the risk markets. Powell's most recent pronouncement is clearly aimed at not producing a market reaction that inadvertently tightens financial conditions. Of course, the first question of the presser went right at this change and Powell explained that while the 1995 and 1998 mini-easing cycles were potentially comparable periods of successful mid-cycle adjustments, a more extensive series of rate cuts could be appropriate this time if the economy turns down further. For balance, Powell also reiterated that the FOMC's base case remains one of moderate growth in the United States despite ongoing uncertainty from trade policy and continued global weakness, particularly in Europe and China.

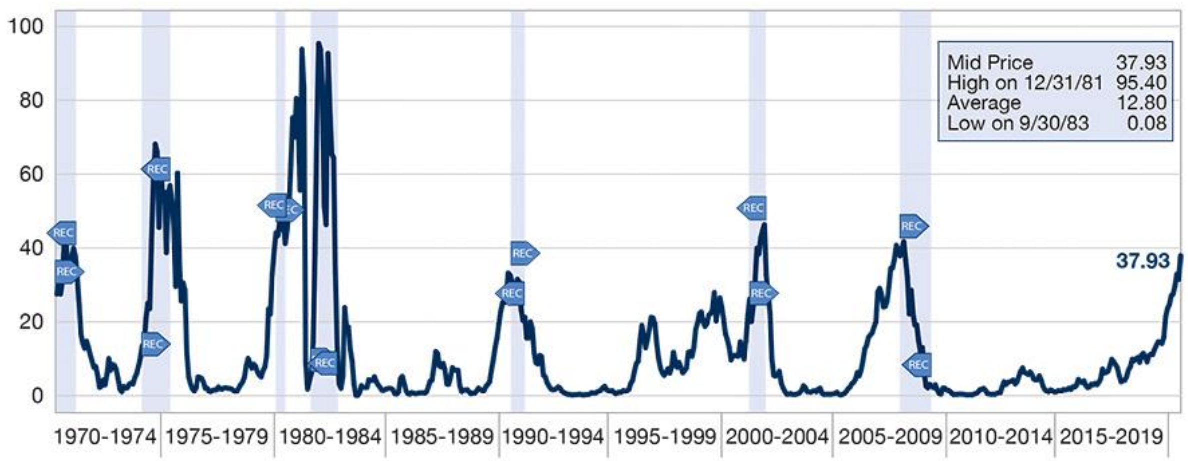
Chair Powell also emphasized that significant risks to the FOMC's outlook persist and, consequently, policy is NOT on a preset course. In response to a question about negative interest rates (NIRP), Powell was wisely dismissive of that as a viable policy tool and instead chose to emphasize both balance sheet policy (quantitative easing or "QE") and forward guidance as tools the FOMC can deploy should it deem them necessary. In response to another question about the efficacy of these aforementioned policies, Chair Powell did briefly discuss fiscal policy in the context of being more forceful—to address potential growth, productivity and labor force participation—and as such can do more than monetary policy in the long run.

Nonchalance Over Stress in the Repo Market
Surprisingly, the statement made no mention of the recent stress in the repurchase (repo) market that forced the Fed to conduct open market operations to temporarily add reserves to the system. When asked, Chair Powell was dismissive of the market stress and said it has no implications for monetary policy. Considering the focus on the repo market stress over the past 48 hours and the absence of a longer term solution (something the FOMC has been studying), the FOMC's nonchalance seems a bit cavalier to many market participants. Apparently, the FOMC is comfortable handling the repo market stress through temporary open market operations, as another round was announced after the press conference ended.

Chances of Soft Landing Are Very Remote

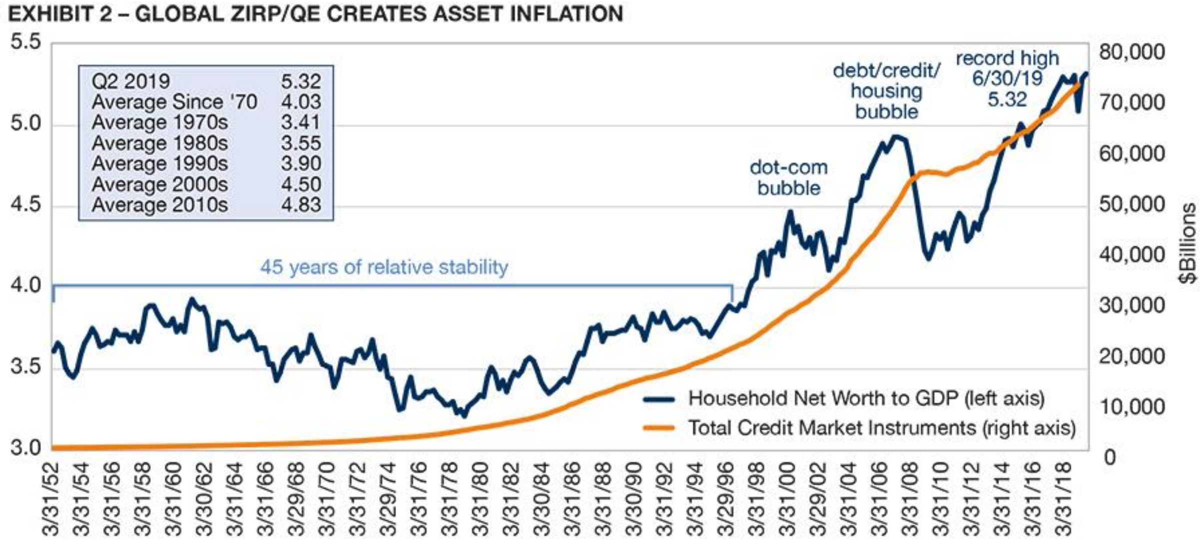
Looking forward, the FOMC offered very little in the way of forward guidance beyond their fairly typical “dovish” leanings to respond as appropriate to extend the expansion. The probability of the Fed “soft landing” this extended economic cycle is extremely remote. Unfortunately, as is always the case, by the time the FOMC finally acknowledges the likelihood of more challenged economic conditions and the consequent need for a full blown easing cycle, the economy will already be in a full-fledged recession. Exhibit 1 below illustrates the rising probability of recession according to a model published by the NY Federal Reserve. The backdrop for investment grade fixed income therefore remains a “lower for longer” term structure of rates and persistent yield curve inversion until the FOMC is forced to react and ease more aggressively. This curve inversion has become a popular signpost of potential recession and risk market underperformance, but in fact it is the subsequent steepening that accompanies an aggressive easing campaign that engenders the pronounced risk aversion that comes at the end of every cycle. Exhibit 2 below depicts the elevated level of asset prices by computing a ratio of household net worth to the real economy (GDP); the over-reliance on monetary policy to extend every expansion since the 1990s obviously creates asset inflation – what’s come to be known as the everything bubble. Inevitably a return to a zero interest rate policy (ZIRP) regime and more QE/forward guidance will follow. The question is, will this playbook work next time?

EXHIBIT 1 – NY FED PROBABILITY OF RECESSION 1970 to Current



Source: New York Fed, Bloomberg. Data as of September 19, 2019.

EXHIBIT 2 – GLOBAL ZIRP/QE CREATES ASSET INFLATION



Source: Bloomberg, Federal Reserve Bank of St. Louis.

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