Thursday, August 1, 2019

The first cut is the deepest?

On July 31, the Federal Reserve’s Open Market Committee (FOMC) cut the short-term Fed Funds interest rate by a quarter of a percent, or 25 basis points, marking its first interest rate cut in over 10 years. The cut was well telegraphed by the Fed and fully priced in by the markets, so the real uncertainties related to the Fed’s and Chairman Powell’s messaging of future direction.

On that front, Chairman Powell’s relatively balanced, rather than dovish, posture left the markets wanting. He described the cut as a mid-cycle adjustment rather than the first of a protracted easing cycle. The S&P 500 finished down over 1% on the day and the dollar rose firmly against the Euro. Even the FOMC vote to cut rates was skewed by two dissenters who preferred to leave rates at existing levels. The rationale laid out by Chairman Powell for the cut centered on muted inflation, slowing global growth, and circumspect business investment – the latter two being weighed down by trade restrictions and related business uncertainty.

Chairman Powell did, of course, leave the door open for future cuts and stressed the importance of incoming data and risks to the continued economic expansion. He did not, however, “tee up” a September cut the way that the Fed’s June pronouncements guided the markets toward this July cut. By the end of the trading day, the pricing of futures market contracts based on the Fed Funds rate pointed toward lower probabilities of more aggressive rate cuts through year end (Figure 1).

Figure 1: Fed Rate Action in 2019: Market-Implied Probabilities for December Meeting

In a likely deliberate choice of words, Chairman Powell characterized the July 31 rate cut as “insurance.” Recent stories in the financial press have characterized “insurance” rate cuts as having more favorable stock market implications on a go-forward basis. In reality, whether a rate cut constitutes “insurance” can only be fully known in hindsight, and stock market performance over the 12 months following a first rate cut is quite varied (Figure 2). At present levels, interest rates are not the problem. Ultimately, support for the equity markets will need to come from the drivers

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of healthy growth in consumer spending, business spending, productivity, and earnings – along with contained inflation. Chairman Powell focused explicitly on business spending, global growth, and trade as the primary risks to continued economic expansion. With the highly anticipated rate cut now behind us, we believe that the markets will also focus on how these risks are playing out.

Source: BMO Wealth Management, Bloomberg Financial
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