Flash

Thursday, 01 August 2019

Fed rate cut not the start of a long easing cycle?

Fed cuts Fed funds target by 25 bp as widely expected

Rate cut mainly an insurance against external risks and lower inflation

Powell doesn't see the start of a long easing cycle as US economy is still in good shape

Markets were postioned for a softer Fed: the yielde curve flattens, the dollar rallies and equities fell prey to profit taking

The Fed as largely expected **cut is its Fed fund target range by 0.25% to a range of 2.00-2.25% yesterday.** At the same time, the Fed announced that it will **conclude the reduction of its aggregate securities holdings** (balance sheet roll-off) in August, two months earlier than previously indicated. The decision was **not unanimous:** Ester George and Eric Rosengren dissented and preferred to keep the policy rate unchanged.

In its policy statement, the language in the economic assessment was little changed. Economic activity has been rising at a moderate pace. Job gains have been solid, and the unemployment rate has remained low. Growth in household spending has picked from earlier this year, but business investment has been soft. Inflation is running below 2 percent and market-based measures of inflation compensation remain low.

Despite a solid US economic performance, the FOMC statement **'justifies' the rate cut by the implications of global developments for the economic outlook and muted inflation pressures.** In this respect, yesterday's rate cut can indeed be considered as **a pre-emptive act** to ensure a sustained expansion of economic activity and inflation to reach to symmetric 2 percent target. The guidance on future Fed action was rather neutral. The Fed said it will monitor incoming information (thus not only incoming data) and will act as appropriate.

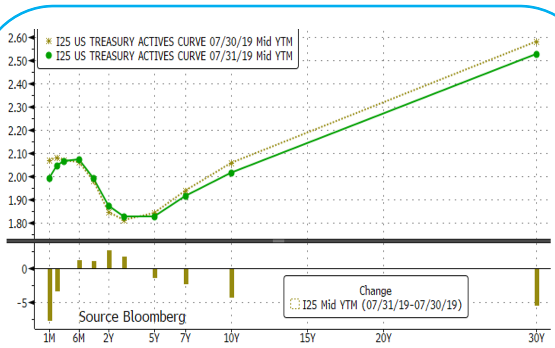
At the **press conference**, the Fed chair labelled the rate cut as a **mid-cycle policy adjustment.** In this respect, Powell clearly signalled that, at least for now, **it doesn't consider yesterday's cut as the start of a long series.** This isn't necessary as it still sees a favourable baseline outlook for the US economy. The rate cut should mainly be seen as an insurance against a weak global economy, in particular in Europe and China, and against the potential impact of global trade tensions. The **lower** average assessment within the FOMC on what a neutral policy rate is (June dots), also **reinforced the case for a lower rate path.**

Overall the tone at the press conference was not that dovish as the Fed president stressed the positive current outlook for the US economy. Powell also believes that the change in the Fed policy/guidance during this year, via easier financial conditions, helped to support/stabilize US economic activity.

The motivation for the **two dissenters** was mainly financial stability considerations, but Powell indicated that he sees financial stability vulnerabilities to be rather moderate currently. He was very brief on the reasons for the early stop of the balance sheet run-off which he labelled as a simple issue of simplicity and consistency. Powell admitted that there are different views on policy within the MPC, but that the committee is unified on making best policy to reach its mandate.

The Fed didn't openly signal that it will cut rates further. However, the formulation that the Fed **will contemplate the future path of target range and act as appropriate to**

sustain the economic expansion, gives the Fed room to act further out. In its assessment toward a potential rate cut, the Fed will probably give **more weight to global economic risks/developments, the impact of trade tensions on the economy and on inflation,** rather than strictly on the economic development with the US economy.



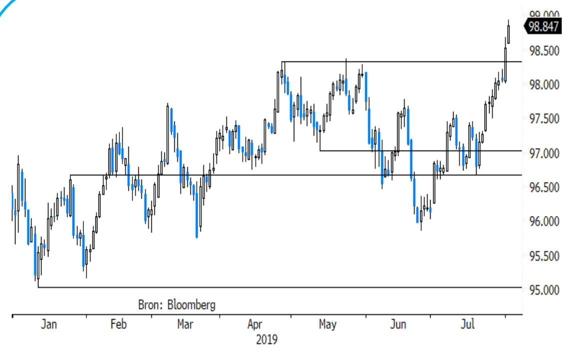
US yield curve flattens as markets expected/hoped the Fed to be more dovish.

Yield curve flatting and stronger dollar

The market reaction showed some 'disappointment'. The 25 bp rate cut was no surprise, but **most investors expected a more dovish tone.** The US yield curve flattened with the 2-y yield up 2.6 bp in a daily perspective and the 30-y yield declining 5.5 bp. The 2-y yield ticked up sharply but briefly when Powell said that the rate cut was a mid-cycle policy adjustment. Even so, **the flatting of the yield curve is a bit 'annoying' in a context where a CB tries to raise inflation and inflation expectations.**

The dollar rallied after the policy announcement and hovered near the EUR/USD 1.11 key support area at the start of the press conference. **The US currency extended gains as the tone of the press conference was less dovish than expected.** EUR/USD closed the day at 1.11 dropped to the 1.1076. The EUR/USD decline continues in Asia this morning. The trade weighted dollar also cleared the 98.35 resistance, improving the short-term technical picture for the dollar.

The major US equity indices lost about 1.0% as investors had hoped for a more dovish policy stance. Equity losses in Asian dealings this morning is modest. The rise of the dollar (USD/JPY) probably helps to prevent bigger losses, at least in some markets (especially Japan).



USD (trade-weighted-DXY): dollar breaking above 98.35 resistance, improving the ST technical picture.

Peter Wuyts , KBC Brussels

Contacts

Brussels Research (KBC)		**Global Sales Force**	
Mathias Van der Jeugt	+32 2 417 51 94	Corporate Desk(Brussels)	+32 2 417 45 82
Peter Wuyts	+32 2 417 32 35	Institutional Desk(Brussels)	+32 2 417 46 25
Mathias Janssens	+32 2 417 51 95	CBC Desk (Brussels)	+32 2 547 19 19
Dublin Research		France	+32 2 417 32 65
Austin Hughes	+353 1 664 6889	London	+44 207 256 4848
Shawn Britton	+353 1 664 6892	Singapore	+65 533 34 10
Prague Research (CSOB)		**Prague**	+420 2 6135 3535
Jan Cermak	+420 2 6135 3578		
Jan Bures	+420 2 6135 3574		
Bratislava Research (CSOB)		**Bratislava**	+421 2 5966 8820
Marek Gabris	+421 2 5966 8809		
Budapest Research		**Budapest**	+36 1 328 99 85
David Nemeth	+36 1 328 9989		

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