11 November 2019

FOMC Call Update

Fed on hold for now but may be forced to cut again

On the back of the Fed's new 'wait-and-see' approach and the better-than-expected October jobs report, **we update our Fed call and now expect only one more cut in 3-6M (previously three more cuts).** The timing of the cut is difficult but, as the Fed wants to see how things play out, the March meeting is probably the earliest possibility. Most FOMC members (including the doves) have said they think the current policy stance is appropriate and that it would take a further deterioration of data to make further cuts.

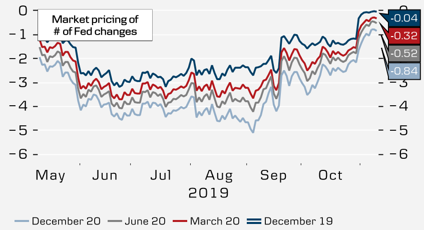
We keep a cut in our forecast profile, as we still believe the US economy is more fragile than the Fed believes and that the renewed trade optimism is unlikely to be enough to trigger a rebound in business investments just yet. Most soft indicators on investment intentions signal a further decline in business investments. In our view, we need a more permanent deal for investments to kick off again (we assign a 50% probability of this happening). The world economy also looks fragile, in particular in Europe, despite the early signs of stabilisation in China.

A few things have surprised us. First, hard data have not been as weak as indicated by the soft indicators. Second, we thought the Fed would deviate from its historical pattern by easing more in this 'mid-cycle adjustment', as inflation and inflation expectations remain low compared with the 2% target, limiting the costs of easing monetary policy. Market-based expectations have rebounded but remain around the level where the Fed made its U-turn at the beginning of the year. Survey-based indicators are at historical lows. Third, the trade war negotiations have come back on track faster than expected.

In this piece, we also take a closer look at how economic indicators usually develop when the Fed makes 'insurance cuts' and 'recession cuts' (see charts from page 2 to 5). **Based on the charts, it is clear the Fed usually begins to cut aggressively when we see a more severe slowdown in private consumption growth and/or jobs growth (i.e. when it is too late).** Now the Fed has revealed it is not going to deviate from this, we probably need a combination of slower private consumption and jobs growth for the Fed to start cutting more. Right now, private consumption and employment are growing at decent paces. The Fed is also relieved that the US 10s2s and 10s3m spreads are now positive again (i.e. investors think the probability of a recession has declined). If core capex moves sharply lower, as hinted by, for example, the CEO confidence indicator, it may change the Fed's thinking as it did in 2001, which was an investment-driven recession.

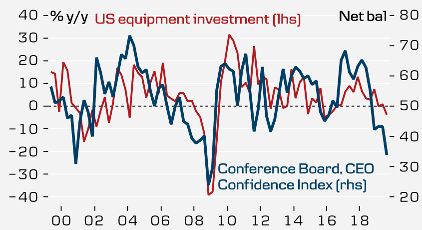
We want to stress that the outlook for the Fed funds rate has become more uncertain and, admittedly, we do not have a strong narrative currently. If hard data begin to move lower as suggested by soft indicators, or we get a setback in the US-China trade negotiations, the Fed may soon cut rates again (if the opposite is true, the Fed is likely to remain on hold; a hike still seems unlikely in this scenario, as Fed Chair Jerome Powell said a hike is not on the cards until inflation starts moving persistently above 2%). In addition, monetary policy is not as expansive as one may think, as the cuts have taken the Fed funds rate only down to neutral. Without more easing, it also increases the probability the Fed will need to cut all the way down to 0%, as a response to a recession.

Current market pricing seems fair



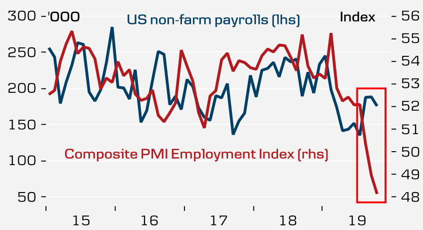
Source: Federal Reserve, Bloomberg, Macrobond Financial

CEO Confidence Index the lowest since the financial crisis – business investments may fall further



Source: BEA, Conference Board, Macrobond Financial

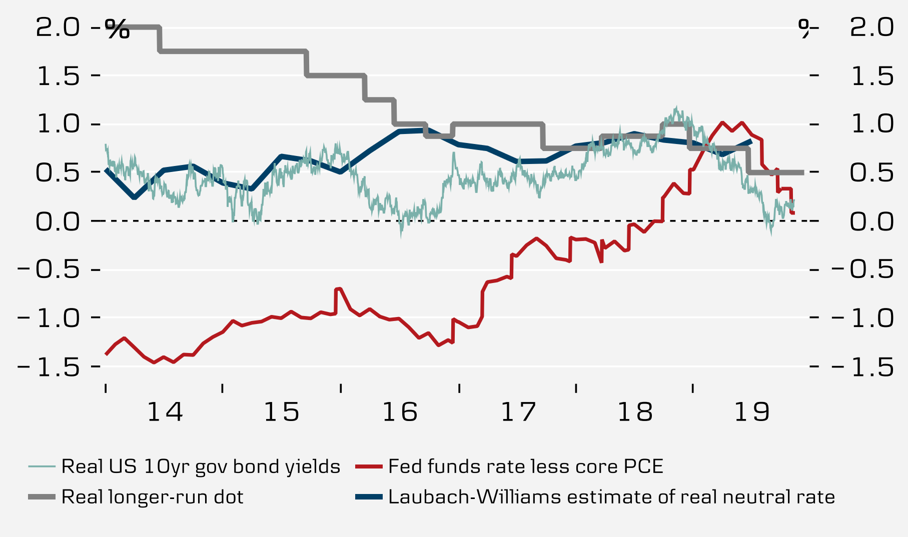
Hard vs soft data gap



Source: BLS, IHS Markit, Macrobond Financial

Senior Analyst
Mikael Olai Milhøj
+45 45 12 76 07
milh@danskebank.dk

Monetary policy is neutral, not accommodative, according to market rates

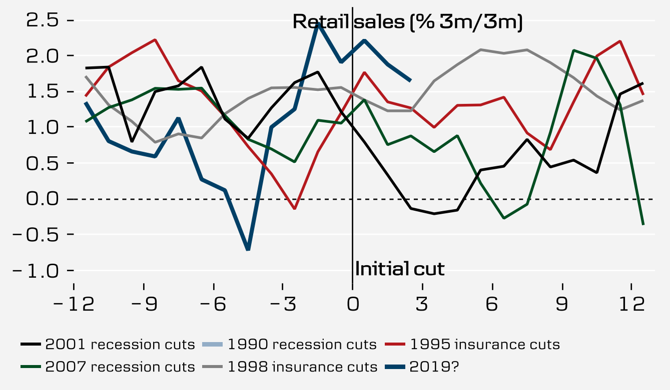


Source: Bloomberg, Federal Reserve, BEA, NY Fed, Macrobond Financial

Insurance vs recession cuts – charts

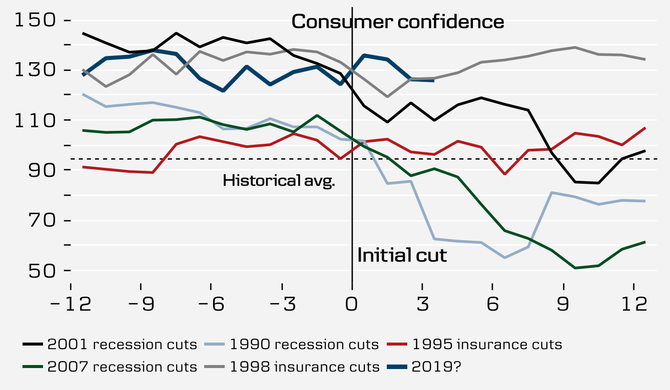
Consumption

Retail sales need to slow more sharply for the Fed to cut aggressively...



Source: Census Bureau, Macrobond Financial

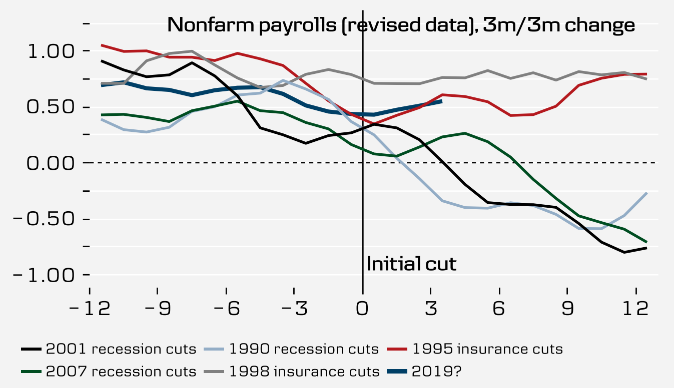
...and consumer confidence usually falls below its historical average



Source: Conference Board, Macrobond Financial

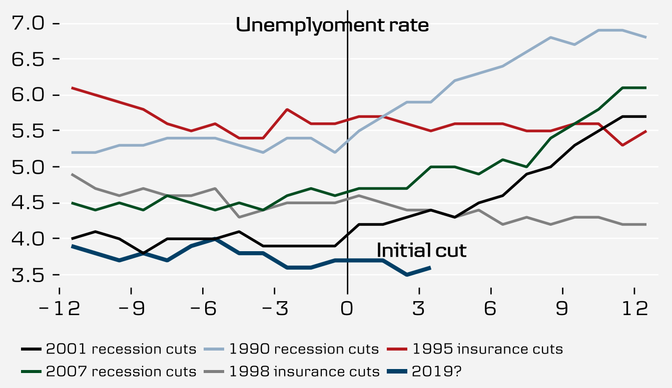
Labour market

Jobs growth usually turns negative when the Fed initiates a 'recession cut' cycle



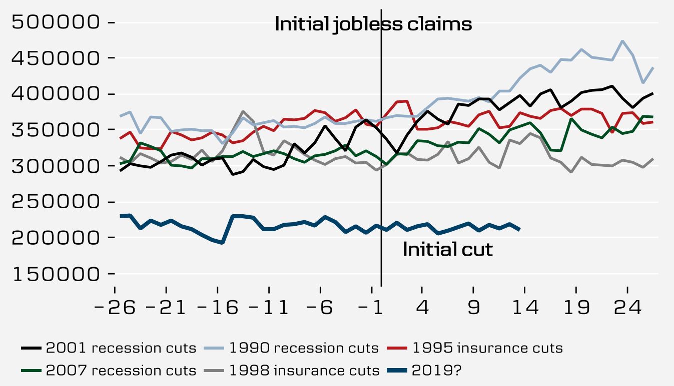
Source: BLS, Macrobond Financial

Unemployment has usually moved sideways during insurance cuts



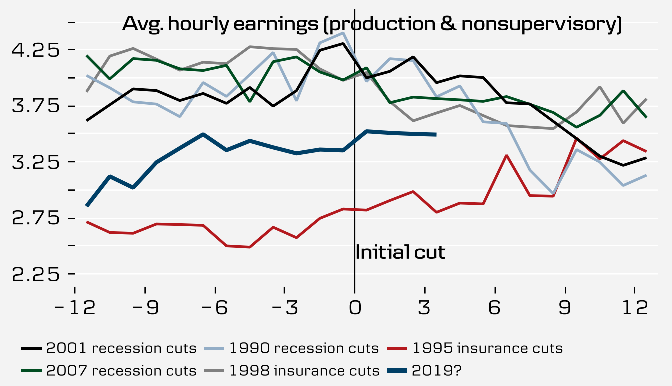
Source: BLS, Macrobond Financial

Claims are moving higher during recession cuts



Source: Department of Labor, Macrobond Financial

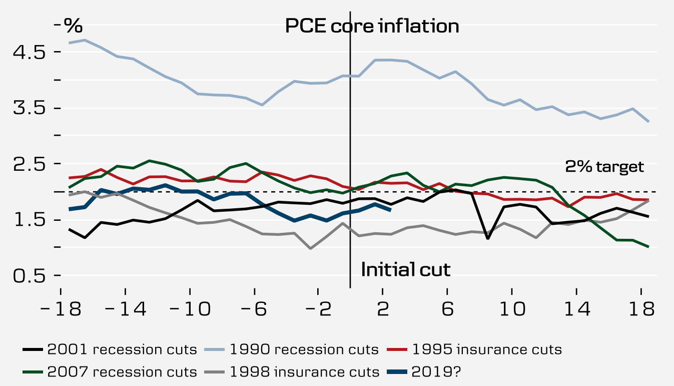
Wage growth has usually peaked when the Fed makes recession cuts



Source: BLS, Macrobond Financial

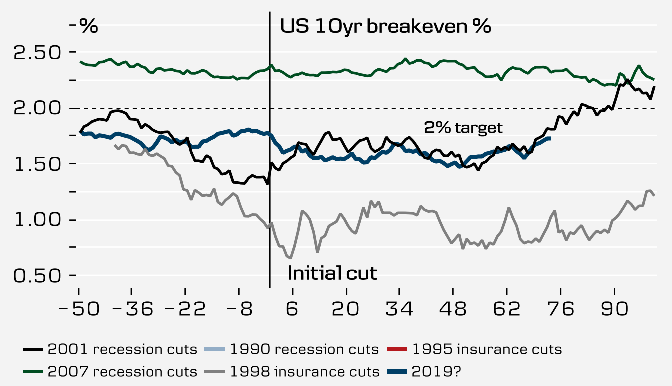
Inflation

PCE core inflation not a good indicator of how aggressive the Fed is...



Source: BEA Macrobond Financial

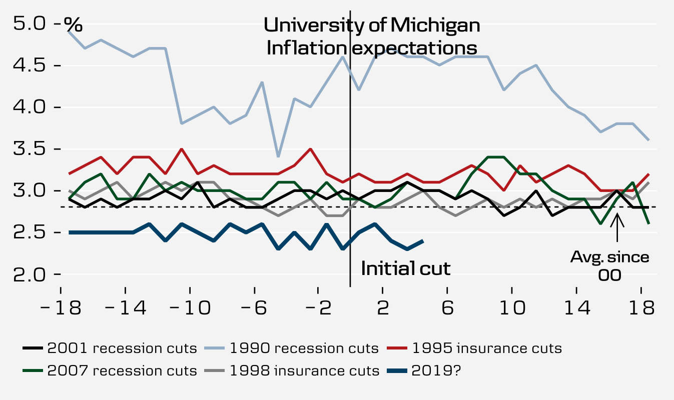
...the same for US 10Y breakeven inflation...



Source: Bloomberg, Macrobond Financial

Note: Past performance is not a reliable indicator of current or future results.

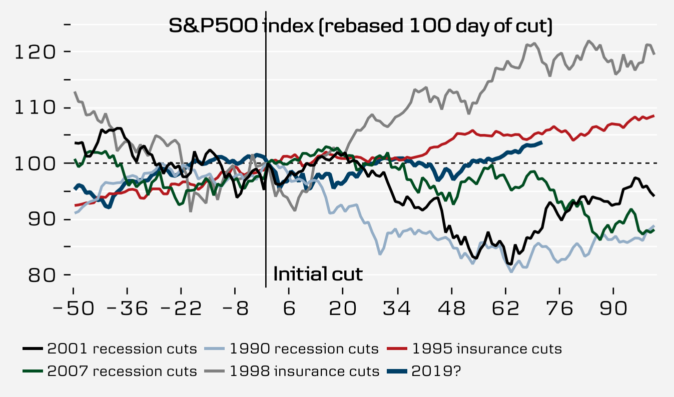
...and survey-based inflation expectations



Source: University of Michigan, Macrobond Financial

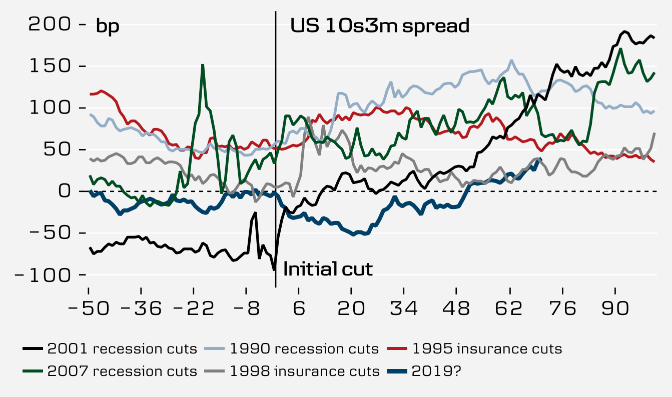
Financial variables

We usually see a rebound in equities after insurance cuts



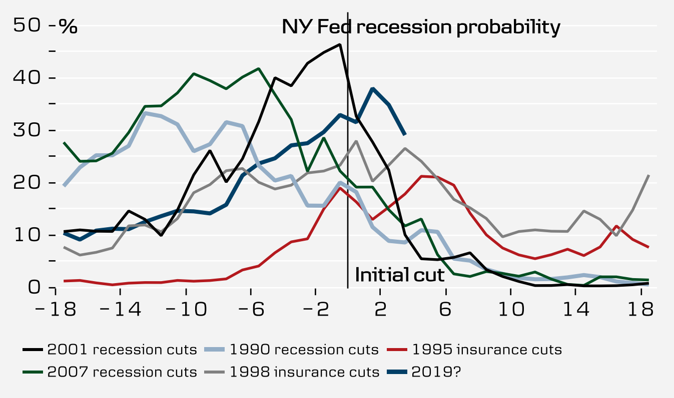
Note: Past performance is not a reliable indicator of current or future results
Source: Macrobond Financial

Fed wants to 're-invert' the yield curve in cutting cycles



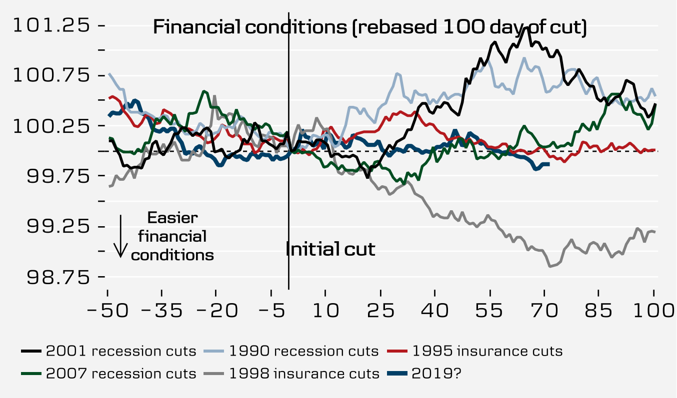
Note: Past performance is not a reliable indicator of current or future results
Source: Bloomberg, Macrobond Financial

Fed wants to lower recession risk by easing



Source: NY Fed, Macrobond Financial

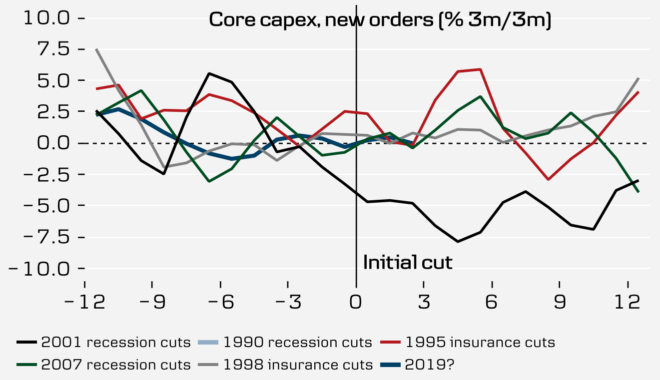
No clear signals from financial conditions



Note: Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index
Source: Goldman Sachs, Bloomberg, Macrobond Financial

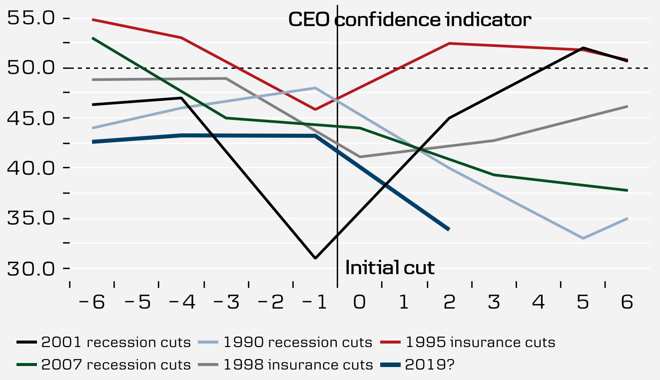
Investment

Fed reacted aggressively to falling investments in 2001



Source: Census Bureau, Macrobond Financial

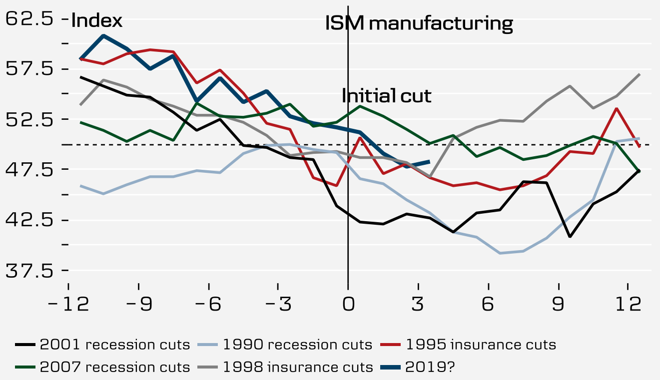
CEO confidence indicator suggests more aggressive Fed easing



Source: Conference Board,, Macrobond Financial

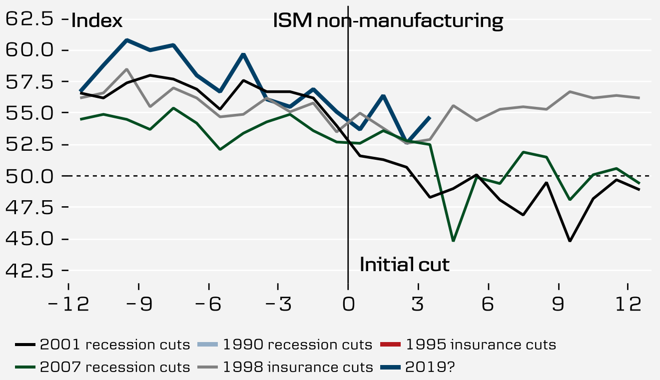
Activity indicators

Slightly lower ISM would justify more easing



Source: Census Bureau, Macrobond Financial

ISM non-manufacturing may need to fall further for the Fed to react



Source: ISM, Macrobond Financial

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