13 September 2019

FOMC Preview

Another Fed cut without pre-committing to further easing

Key takeaways

- **We expect the Fed to cut again next week in line with market pricing.**
- **We expect the Fed to repeat its easing bias and to lower its dot plot to signal one more cut is on the cards but without a pre-commitment to this.**
- **If the Fed cuts next week, we still expect a 25bp cut at each of the next four meetings, taking the target range to 0.75-1.00% in March.**
- **We stick to our 1% target for US 10-year Treasury yields (see overleaf).**
- **We see a potential for the Fed to disappoint the market, which would weigh on EUR/USD. We still look for EUR/USD to trade close to 1.10 on 1-3M.**

Things have worsened since the July cut

At next week's FOMC meeting, we expect the Fed to cut its target range by a further 25bp. The three factors that explained the initial cut in July were (1) higher global political uncertainty, (2) slower global growth and (3) subdued inflation pressure.

Two out of three factors have worsened since July. Donald Trump escalated the trade war (although the tone has been more constructive recently) and data out of China and Europe have disappointed. US inflation has been stronger than expected over the past couple of months but inflation expectations have declined further. Focusing on US growth, both the ISM and PMI indicators show growth has peaked. This is particularly visible in the manufacturing sector, with the ISM manufacturing index now in recession territory. The service sector and private consumption remain robust but there are also signs service sector growth has slowed. There is always the risk that the downturn in manufacturing will spread to the service sector. Nonfarm payrolls have been on the weak side in recent months.

Prior to the Fed blackout period, which began on Saturday, we have heard from most FOMC members, including the most prominent ones. **Fed Chair** Jerome **Powell has said that things have been 'eventful' since the July meeting and emphasised the easing bias that the Fed '*will act appropriate[ly] to sustain the expansion*'**. This view has been echoed by both New York Fed President John Williams and Fed Vice Chair Richard Clarida in recent speeches. **While FOMC members have not pre-committed to more cuts (see table on page 3), Powell did not rule out more easing coming.** We would expect him to have done so if he had disagreed with current market pricing (25bp cut fully priced).

Esther George and Eric Rosengren have laid out the argument for dissenting again. James Bullard prefers a 50bp cut but, in our view, he will probably support the 25bp without dissenting. **We do not expect the Fed to change much in the statement and believe it will repeat its easing bias** ('act as appropriate to sustain the expansion'). The dot plot will lower automatically, simply reflecting that the Fed will have cut twice since last time (assuming the September cut is a done deal). We think the Fed will signal that another cut may be on the cards this year, otherwise, in our view, it is a hawkish signal, compared with both our view and market pricing. The Fed has downplayed the importance of the dot plot.

Things have worsened since the July cut

Three factors behind July cut		
Global political uncertainty	Trade War	↓
Global growth	Euro area	↓
	China	↓
Inflation	CPI	↑
	Inflation Expectations	↓
US growth	ISM manufacturing	↓
	ISM non-manufacturing	↑
	Retail sales	↑

Source: Danske Bank

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We believe the downturn in the manufacturing sector will continue, supporting the case for further Fed easing. The macroeconomic outlook has become more uncertain. The cost of cutting the target range does not appear to be high due to low and stable inflation. If the Fed does not cut, the risk is that higher global trade uncertainty and slower global growth will trigger a slowdown in the US.

Besides a cut next week, we expect four more 25bp rate cuts, taking the target range to 0.75-1.00% at the March meeting next year (see *Presentation – Five more cuts form the Fed (chart pack)*, 20 August). However, we stress that nothing in most recent Fed speeches indicates a larger cut of, for example, 50bp, which is normal outside recessions (we need to see more deterioration in [the labour market]).

Fixed income: expect little impact on US Treasuries

The fixed income market is more or less fully priced for a 25bp cut after the probability of a large 50bp cut has been almost fully priced out of the curve in September. Hence, we expect all market focus to be on the accompanying rhetoric. If Powell still talks about a medium-term adjustment, the recent move higher in yields could continue and the curve 2-10Y could start to flatten again. However, we strongly doubt we are in for a prolonged sell-off in US treasuries and, **given our forecast for five more rates cuts including a September cut, we stick to our 1% target for 10Y US treasury yields.**

EUR/USD looking to repeat July FOMC price action

The market is priced for a 25bp, but is still expecting this to be followed by more rate cuts. If the Fed delivers a 25bp cut next week, the deciding factor will be the forward guidance on interest rates**. Here we see a potential for the Fed to disappoint the market, which would weigh on EUR/USD.** Price action in EUR/USD during the July FOMC meeting could provide a good blue print for what to expect from next week's meeting. EUR/USD dropped some 50pips as Fed only cut 25bp and failed to pre-commit to further rate cuts. We would not be surprised to see a reaction of similar magnitude next week. In the medium term, we still expect Fed to eventually get ahead of the curve in terms of monetary easing and weaken USD and push EUR/USD higher. However, that is likely a story for next year. **In the meantime, we look for EUR/USD to trade close to 1.10 on 1-3M.**

Uncertainty has risen and global growth has slowed since the July cut

Three factors behind July cut		
Global political uncertainty	Trade War	↓
Global growth	Euro area	↓
	China	↓
Inflation	CPI	↑
	Inflation Expectations	↓
US growth	ISM manufacturing	↓
	ISM non-manufacturing	↑
	Retail sales	↑

Source: Danske Bank

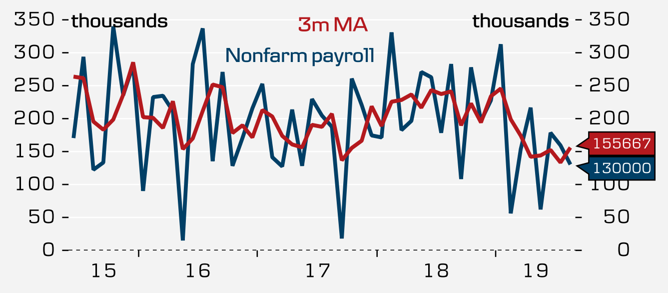
Most FOMC members are inclined to support a rate cut

	FOMC members	Inclined to support rate cut	Comment
Dovish	Bullard (voter)	✓	"I think there will be a robust debate about a 50 bp rate cut"; "Our job here is to get the yield curve uninverted"; "I think we can afford to be kind of dovish here"
	Kashkari (non-voter)	✓	Fed should ease, use forward guidance
Centrist	Brainard (B) (voter)	✓	"We're commited to sustaining the expansion and I'm certainly monitoring developments for their implications for the outlook and I'll continue to be very attentive to them"
	Kaplan (non-voter)	✓	"I'm very constructive on the thought that we may need to make an adjustment and be open to making an adjustment in our policy rate"
	Williams (voter)	✓	"Fed will act appropriate to sustain the expansion"; "Growth is moderate, and economic data on economy are mixed"
	Clarida (B) (voter)	✓	"Obviously the global outlook has worsened since our July meeting. The global economy is slowing and there are disinflationary pressures"
	Powell (B) (voter)	✓	"Three weeks since our July meeting have been eventful", "further evidence of a global slowdown"; "will act as appropriate to sustain the expansion"
	Evans (voter)	✓	"As long as inflation continues to behave the way that it has, I think we have capacity to pursue these accommodative stances in support of the economy and sustaining the expansion"
	Daly (non-voter)	✓	"I worry that negative sentiment could be self-fulfilling"; "Low inflation means Fed can let economy run hot"
	Quarles (B) (voter)	→	"Basic principles of risk management in a low neutral rate environment with compressed conventional policy space would argue for softening the expected path of policy when risks shift to the downside"
	Barkin (non-voter)	→	"With the risk of inflation muted, the FOMC decided earlier [to cut cates], with the goal of providing a little insurance for the continued growth of the economy. We are monitoring its impact"
	Bowman (B) (voter)	→	No speeches
	Bostic (non-voter)	→	No speeches
Hawkish	Mester (non-voter)	✕	"I could see scenarios where we hold rates steady. I could see scenarios where we move the rate down. I think we just have to take the time to really evauluate"
	Harker (non-voter)	✕	"I think we should stay here for a while and see how things play out"; "I don't think we need to act right now"
	George (voter)	✕	"not ready to provide more accommodation to the economy without seeing an outlook that suggests the economy is weaker."
	Rosengren (voter)	✕	"Fed shouldn't ease monetary policy again unless domestic outlook darkens."

Source: Danske Bank

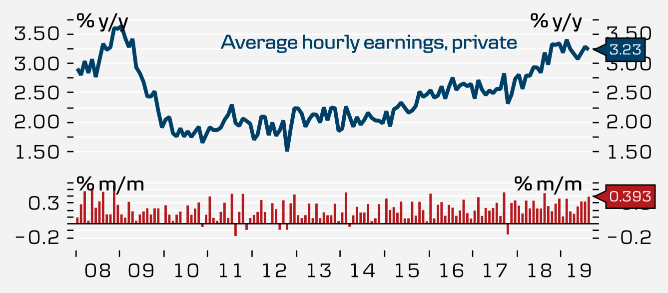
Charts

Employment growth has slowed



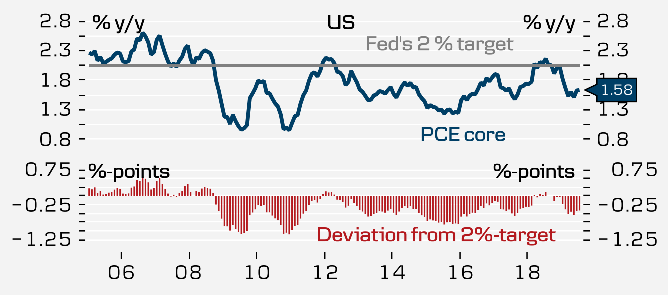
Source: BLS, Macrobond Financial

Wage growth seems to have peaked for now



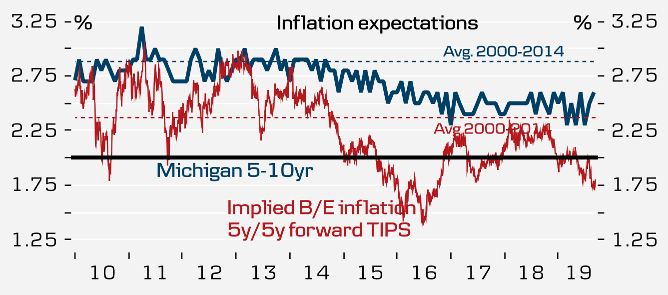
Source: BLS, Macrobond Financial

PCE core inflation is running well below 2% target but CPI inflation has surprised to the upside



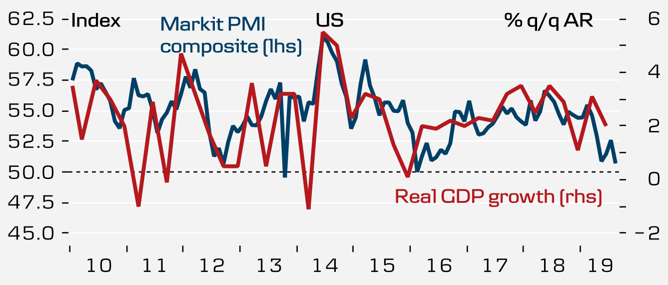
Source: BEA, Macrobond Financial

Inflation expectations still below historical average



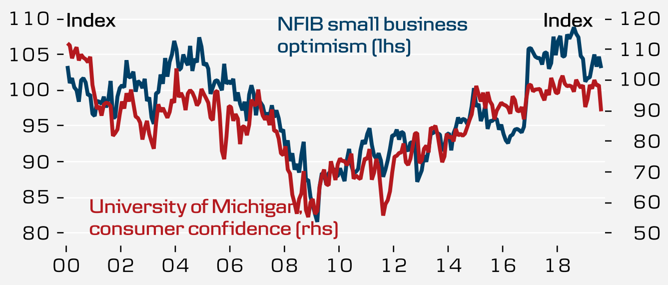
Source: Michigan, Bloomberg, Macrobond Financial

Markit PMI composite signals weak growth in early Q3



Source: BEA, IHS Markit, Macrobond Financial

Optimism has declined somewhat



Source: NFIB, University of Michigan, Macrobond Financial

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