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TRENDMACRO LIVE!

On the July FOMC

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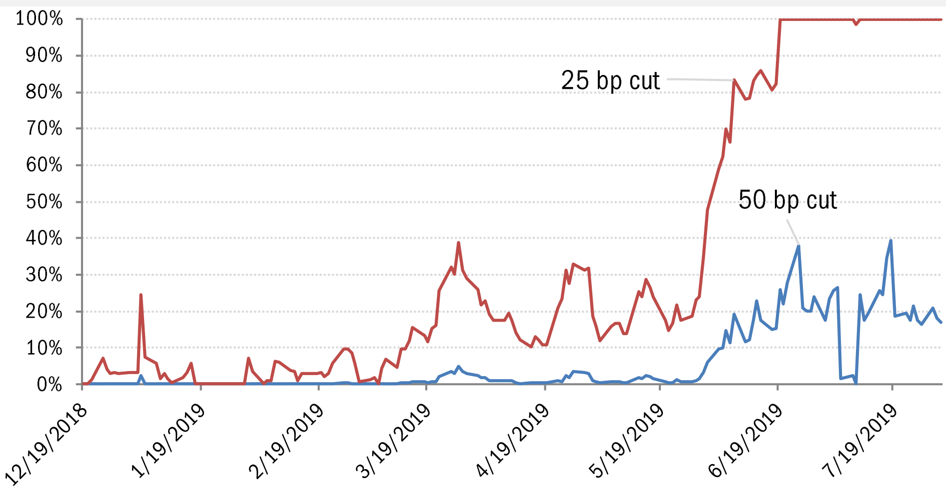
Donald Luskin

One small step for the Fed. It should have been a giant leap. Then there was that gaffe…

The FOMC cut the target funds rate by 25 bp to a range of 2% to 2.25% – and the interest rate on overnight reserves (IOER) was lowered 25 bp from 2.35% to 2.10% – *approximately as expected*.

- We say "approximately," because futures markets were assigning about a 20% probability to a 50 bp cut. That expectation for a larger cut has come down over the last couple weeks (please see the chart below, and "FOMC Preview: 25 or 50?" July 19, 2019). *But, to put it simply, it remains the case that one out of five market participants is disappointed by just 25 bp*.
- We had thought there was a better-than-market chance of 50 bp, seeing it as something of a "whisper number." We've been concerned that there would be market turbulence if we didn't get it (see "Video: What you're not hearing about capex, housing and next week's FOMC" July 25, 2019). As it turned out, there wasn't much reaction in the immediate aftermath of the statement's release. *But the reaction came a little later when Powell started talking*.
- The initial calm was because at least today's little-changed post-meeting statement did nothing to contradict the cautious outlook of last month's, driven by unspecified "uncertainties" (for a complete

Futures-implied probability at July FOMC meeting, from December 2018 FOMC



Source: Bloomberg, TrendMacro calculations

Update to strategic view

US FED, US MACRO, US STOCKS: A 25 bp cut, but some component of the market was expecting 50 bp, and that larger cut was objectively the right move. Market reaction was indifferent at first, because the statement rhetoric was appropriately dovish, supporting future cut expectations. And an earlier-than-expected end to balance sheet drawdown will stabilize the Fed's holdings at a level $70 billion higher than previously thought. But Powell fumbled in the press conference by calling the cut "a mid-cycle adjustment," which implies one-and-done. We expect this error will be reversed in the coming week. 25 bp doesn't un-invert the funds/10-year curve. 50 would have been better insurance against a slippery slope leading back to the zero-bound. With FOMC participants already admitting to heightened uncertainties, low inflation and the abandonment of Phillips Curve worries, that insurance would have been free.

[Strategy dashboard]

red-line comparison, see [“Data Insights: Federal Reserve”]() July 31, 2019). That key word remains, now augmented by worries about “the implications of global developments.”

- *And there was a dovish surprise, albeit a small one: the drawdown by non-reinvestment of the Fed’s Treasury and MBS holdings will end in August, two months earlier than previously announced. On the face of it, that means those holdings will stabilize at a level about $70 billion higher than expected.*
- There were two dissenters who would have preferred no cut – congenital hawk Esther George of the Kansas Fed, and Boston’s Eric Rosengren. We don’t assign any particular importance to this, except to note that this is the second FOMC in a row in which Chair Jerome Powell has had to endure dissents. Perhaps President Donald J. Trump’s relentless needling has eroded his chairmanical aura of leadership.

But, as usual, things started getting worse as soon as Powell started talking in the post-meeting press conference. *Equities started to fall, and the 2-10 curve sharply narrowed, the moment Powell said, in response the very first question – or, rather, in an unforced error that had nothing to do with the actual question – that today’s cut was “essentially in the nature of a mid-cycle adjustment to policy.” This can all too easily suggest one-and-done.*

- *A later questioner specifically asked Powell to flesh out what he meant. Lacking the good sense to read the questioner’s concern – and her kindness in giving him the opportunity to walk back a gaffe – Powell just doubled down, saying “I’m comparing it to the beginning of a lengthy cutting cycle.”*
- *OMG! Then yet another questioner asked about that same phrase! Happily, Powell observed the First Law of Holes, that is, finding one’s self in one you should stop digging. Powell retreated to a generic “data dependency” argument, and as of this writing that seems to have instantly drawn a line under the equity market’s tantrum.*
- *Whoa! Then a fourth questioner asks about it yet again, explicitly pressing Powell to deny that he is signaling one-and-done. Powell seemed to us somewhat peevish when he finally said the right thing: “I didn’t say it’s just one cut, or anything like that.”*
- *Okay, we know what he was trying to do here. He is trying to say he’s not expecting a recession that will necessitate a whole easing cycle. But he is a lawyer, not an economist. He speaks economics as a second language, at best. We expect that Powell and other Fed speakers will be busy over the coming week undoing the damage from this phrase.*

Separate from any prediction or expectation, we are quite sure that 50 bp would have been the right move, and Powell didn’t make it.

- *The yield curve demands it.* Coming into today’s meeting, the spread between the funds rate and the 10-year Treasury yield was

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Recommended Reading

Apollo 11: The Complete Descent
David Woods
Apollo Flight Journal
July 3, 2019

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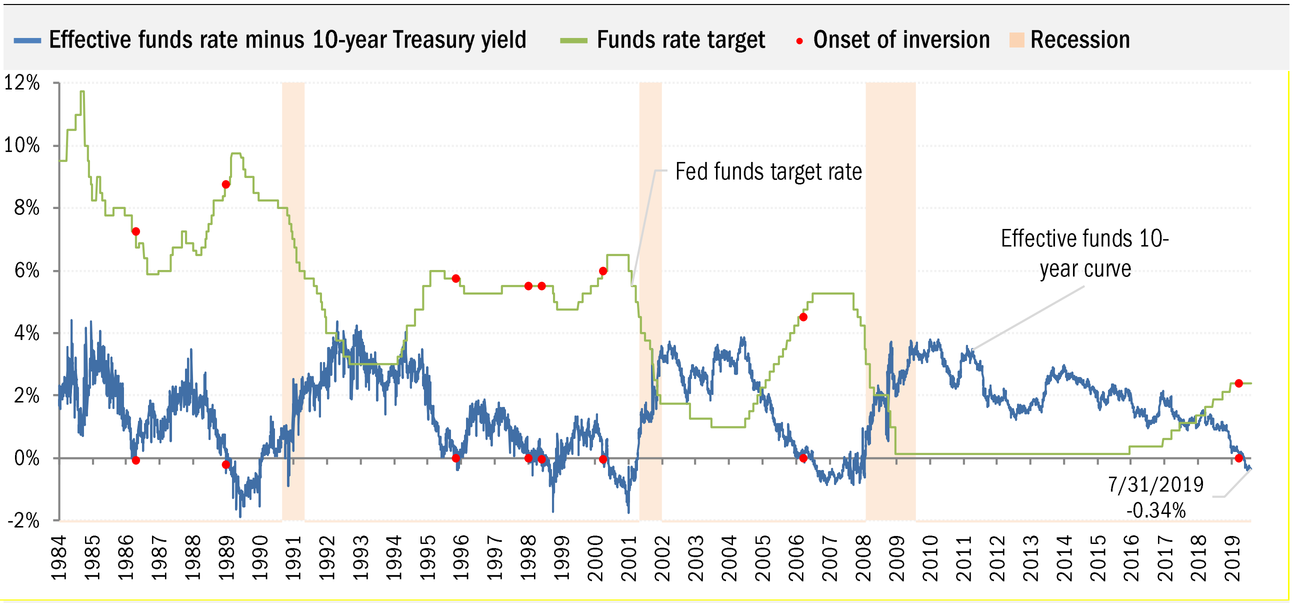
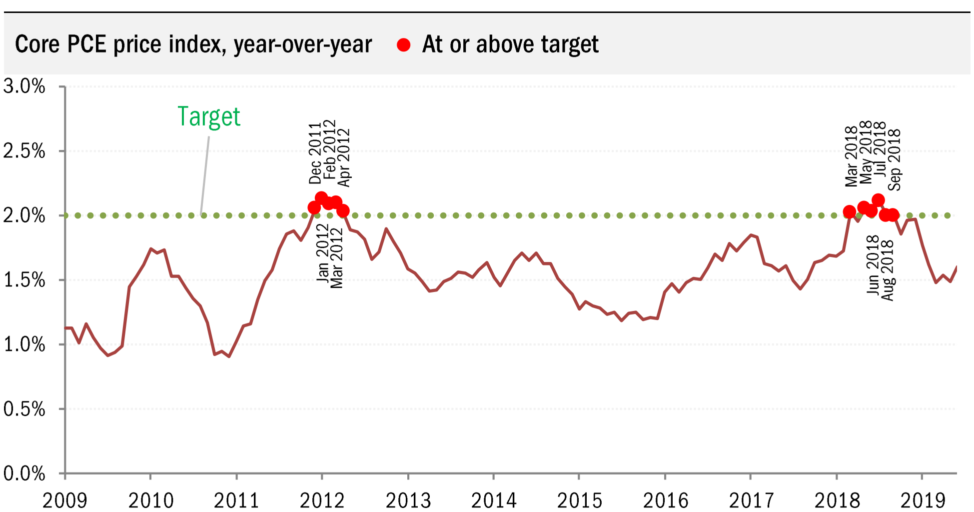


Source: FRB, Bloomberg, NBER, TrendMacro calculations

inverted by 35 bp. [Powell himself has said](#) such an inversion is evidence that "your policy's tighter than you think" (please see the chart above, and among many, ["It's So Time to Cut Rates"](#) June 3, 2019). All else equal, today's 25 bp cut isn't enough to un-invert that curve. It would take 50 bp. At just 25 bp, "your policy's *still* tighter than you think."

- The FOMC statement, both this month's and last, speaks of "muted inflation pressures." This is quite an understatement. Inflation has been "muted" for a decade, during which the Fed threw everything but the kitchen sink at it, and rarely achieved the target of 2% (please see the chart below). With no inflation constraint – indeed, the opposite, a demand-effect from too-low inflation – if there's a case for a cut at all, why not a larger one?
- At the same time, Powell has all but admitted that the Phillips Curve is dead as an inflation risk that might lurk beyond the visible statistics (see ["Video: What you're not hearing about Alexandria](#)

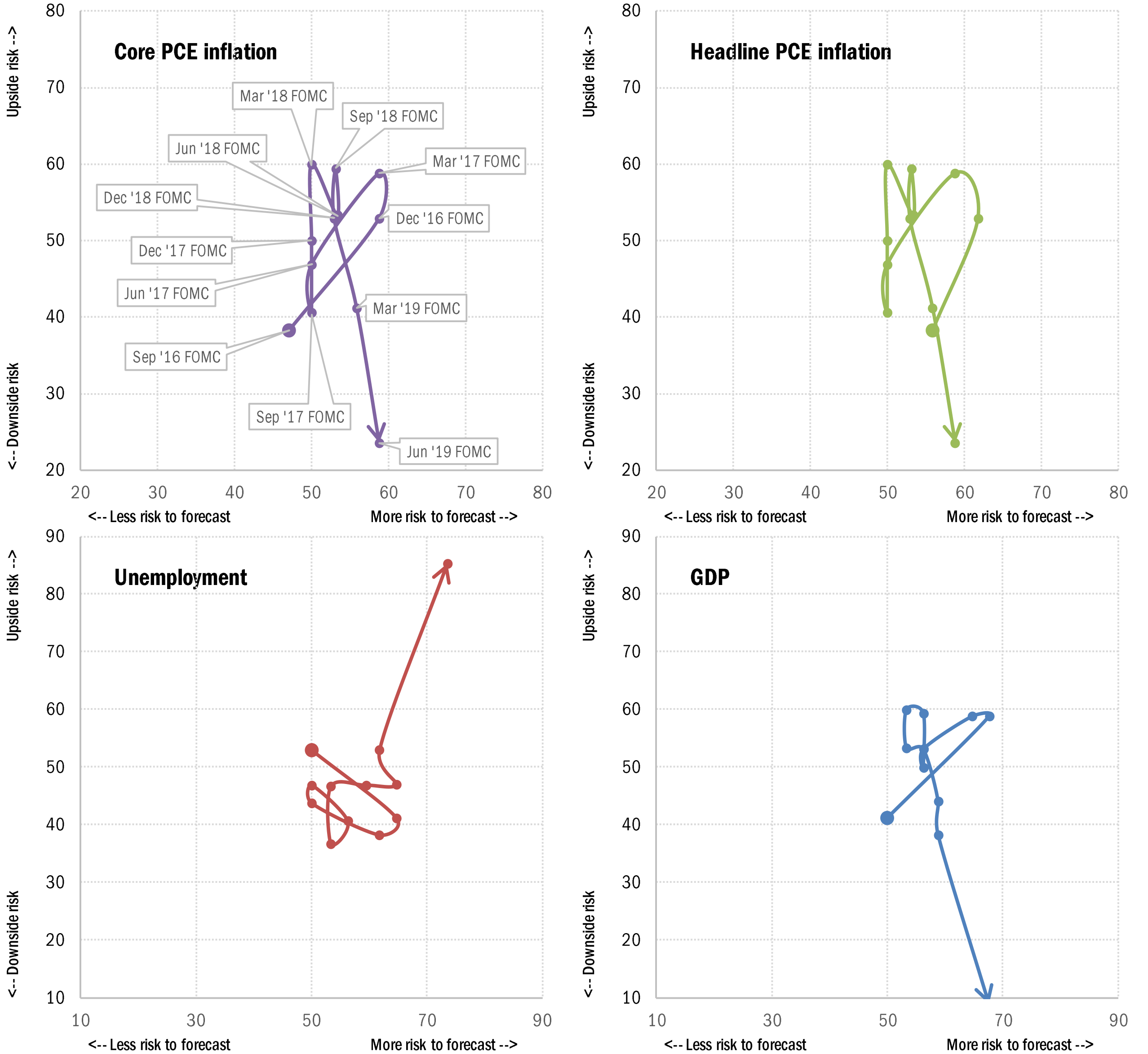


Source: BEA, TrendMacro calculations

Ocasio-Cortez and Jerome Powell" July 11, 2019). Even for dead-enders who still cling to their belief in the curve, it is rendered irrelevant by the concession in the June FOMC's Summary of Economic Projections that the longer-run range of "full employment" is 3.6% to 4.5%, which today's actual reading of 3.7% lives unthreateningly within.

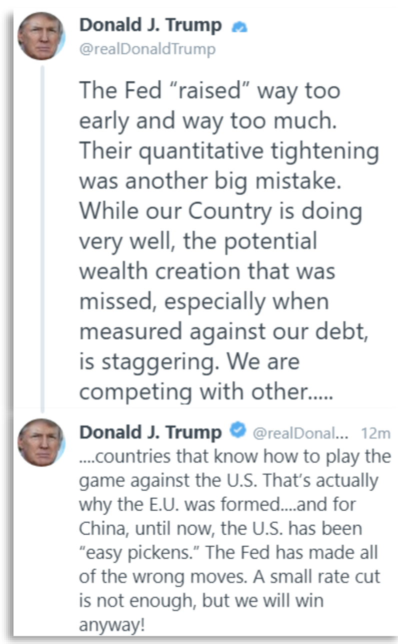
- Finally, if we are to give any credence to the Fed's concern with "uncertainties," then given all the other evidence, why not be sure that adequate "insurance" – as former Chair Alan Greenspan would put it – is in place? Why skimp? Indeed, Powell himself used the word "insurance" as an umbrella rationale for today's cut, when asked in a question to resolve the murky swirl of data that seems to

Diffusion indices of forecast risks reported by FOMC participants in Summary of Economic Projections
From ● September 2016 FOMC to → June 2019 FOMC



Source: FRB SEP, TrendMacro calculations have triggered it.

- *We hear all the time that with rates already so near the zero-bound, the Fed should be parsimonious with its "bullets." We think that's exactly backwards. With the zero-bound near, it's all the more important to make sure that the economy doesn't start tumbling down a slippery-slope. Better to slay the risk early, while it's still small, while you still can.*
- We would think this view should have particular salience for the FOMC considering the state of fright the members seem to be in, revealed in their self-assessments of the forecast-risk in the June FOMC's Summary of Economic Projections. *For all four forecasting categories – inflation, core inflation, GDP and unemployment – participants are reporting both record levels of uncertainty, and record levels of bearishness* (please see the charts on the previous page). It's almost difficult to believe they didn't do a cut in June, given this attitude.
- *Why didn't they, and given everything else we have cited, why didn't they do 50 bp today?*
- We expect the reality is that the FOMC, and Powell especially, are experiencing intensely confusing and distracting psychological pressures that have *frozen them into a bureaucratic stupor in which they believe, wrongly, that making no moves or small moves is the risk-minimizing thing to do.*
- Bureaucrats – especially committees of bureaucrats – always start there anyway. Their first imperative of survival is to avoid blame, and they always believe, wrongly, that they can escape blame by doing *nothing*, while they would invite it by doing *something*.
- When forced to act, they prefer a *small* something to a *large* something. Most unfortunate, considering that reality and bureaucratic imperatives are two very different things. When you are being chased by a tiger, small steps are hardly risk-minimizing.
- Greenspan always took that into account whenever he presided over a new turn in rates. He knew that when you finally act you are too late, by definition – so make the first move a bigger-than-normal one. There just may be a tiger out there.
- But all the bureaucratic imperatives are especially salient now, because the FOMC is being forced to act at least in part as a consequence of its own mistake last December, an unnecessary rate hike accompanied by forward guidance that failed to deliver appropriately dovish offsetting reassurances (see "On the December FOMC" December 19, 2018s and "It's Not 'Quantitative Tightening' – It's Powell" December 20, 2018). *It's naïve not to think that the FOMC wouldn't prefer a smaller cut here for no better reason than that a larger one would amount to a larger confession of error.*
- And then there's Trump. Powell is in a no-win situation versus the President who appointed him. Because of Trump's constant hectoring, anything Powell does or doesn't do, right or wrong, will be interpreted in the light of potential presidential interference. *We can't rule out that Trump's*



relentless calls for a large rate cut made such a cut politically impossible for Powell.

- Or we could imagine that Trump is really a master persuader whose real aim was to leave no chance that the FOMC wouldn't cut at all (well, after all, this *is* the first rate target change for a July meeting in 14 years). This way, a mere 25 bp seems like an act of defiance, (though when compared to where we were in December it is one of obeisance). But then again Powell has himself nicely snarled up with his "uncertainty" narrative driven by "trade tensions." For Powell to give the all-clear signal on the economy and not cut at all would be to admit that Trump's trade policies aren't so bad after all. That would be very embarrassing for Powell given the rapid and very satisfactory resolution of intense uncertainties around Trump's threat of tariffs against Mexico – which triggered Powell's caution to begin with (see "Video: What you're not hearing about Trump's tariff gambit with Mexico" June 9, 2019).
- Finally – and this is the most twisted bureaucratic dimension of all – the FOMC rationalizes its blame-minimization approach, in large part, as an imperative that the Federal Reserve never lose its credibility. Yes, it's fantastical. But take our word for it: FOMC members, almost alone among sentient human beings, do believe that that the Fed has some credibility to preserve. And because they believe that, they are concerned that a large cut sends a frightening "signal" to markets that the Fed has "lost confidence" in the economy, or "sees something the rest of us aren't seeing." So better to do a small cut and not spook the horses.
- It was this kind of thinking, we expect, that lured Powell into box canyon with his "mid-cycle adjustment" gaffe. *He never learns. The market doesn't want him to act casual and insouciant, as he did last December with his infamous "automatic pilot" remark. The market wants to know he's got our back.*

So here we are. Bureaucratic imperatives win, reality loses. Again, it's not a lethal mistake, but is a mistake that will at least be paid for in the dimension of opportunity costs (that is, it won't be a terrible world as a result of this, but the world would have been better if they'd done 50 bp). The statement language was appropriately tuned to support market expectations that more cuts are coming. Yes, Powell blew it badly in the presser – again! – by making it seem like today's cut was one-and-done. We are sure that will be aggressively walked back over the coming week.

Bottom line

A 25 bp cut, but some component of the market was expecting 50 bp, and that larger cut was objectively the right move. Market reaction was indifferent at first, because the statement rhetoric was appropriately dovish, supporting future cut expectations. And an earlier-than-expected end to balance sheet drawdown will stabilize the Fed's holdings at a level $70 billion higher than previously thought. But Powell fumbled in the press conference by calling the cut "a mid-cycle adjustment," which implies one-and-done. We expect this error will be reversed in the coming week. 25 bp doesn’t un-invert the funds/10-year curve. 50 would have been better insurance against a slippery slope leading back to the zero-bound. With FOMC participants already admitting to heightened uncertainties, low inflation and the abandonment of Phillips Curve worries, that insurance would have been free.