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Central Bank Watch

Fed signaled high hurdle for policy rate changes

US Fed lowered federal funds rate again on 30 Oct by 25bp to 1.50-1.75%, the third consecutive rate reduction since this July, in line with expectations. Fed viewed that current rates sit at an appropriate level, signaling higher hurdles for further rate reductions. We believe that Fed is very likely to pause the rate reductions after a series of mid-cycle adjustments. Future rate hikes would largely depend on signs of inflation. Overall, Fed is likely to freeze policy rates until it sees material changes to the outlook and US stock market tends to extend its gain.

- **Fed has cut its benchmark rate for three times since this summer from 2.25-2.5% to 1.5-1.75%.** Rate cut by 25bp in Oct remained an insurance cut to sustain economic expansion and counter risks. Fed officials were still split over the decision with two among ten members continued to vote against the decision who preferred to maintain rate unchanged. Fed believed that policy adjustments this year have been providing meaningful support to the economy.

- **Powell became more optimistic about economic outlook as "risks moved in a more positive direction".** Fed viewed that US economy was growing at a moderate rate and the baseline outlook remained favorable. Powell expressed more positive views on economic momentum by emphasizing strong personal consumptions, healthy job market, rebounding housing market and solid consumer confidence. Despite consistent mentions of risks, Powell appeared to get some relief by saying that a phase-one deal between US and China would help to repair business confidence and activities, and odds of hard Brexit have been materially reduced. Powell expected these positive developments to contribute to a gradual return of economic momentum, which implicitly justified a policy rate pause at this moment.

- **Fed has removed "act as appropriate" and viewed current policy in good place.** Since Jun 2019, Fed has begun to use the key phrase "acting as appropriate to sustain the expansion" to signal subsequent rate cuts. In Oct's meeting statement this expression was removed, indicating a shift from further rate cuts. That said, Fed has not gone that far to "being patient", like it did early this year. In our view, Fed is likely to return to data-dependent approach and await to see lagged effects of rate cuts before making any further actions. Fed would monitor the whole range of economic data, with a focus on job market, growth momentum and inflation, instead of presetting a course for monetary policies.

- **Whether to increase rate next year? It's all about inflation.** After two rounds of mid-cycle rate cuts in the mid and late 1990s, Fed added rates back quickly. Whether Fed will do it again at present? Powell said clearly that future interest hike would depend on inflation. Fed members were not thinking about raising rate now because inflation pressures remained muted and inflation expectation was still below 2%. Fed needs to see a significant and persistent move-up in inflation before they consider hiking rates.

- **Fed cut and US GDP beat are positive for short-term market sentiment, but we see risks staying high.** Although history shows that US stock market tends to extend its gains after mid-cycle rate cuts, business fundamentals no longer justify their prices while markets are trading at all-time highs. We need to keep an eye on trade talk and economic data to identify any possible changes of Fed's stance.

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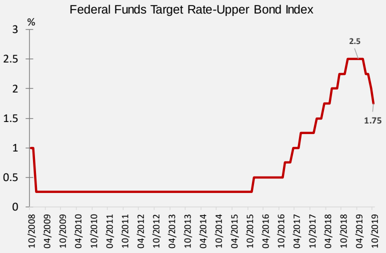
US federal funds target rate (upper bond)



Source: Bloomberg, CMBIS

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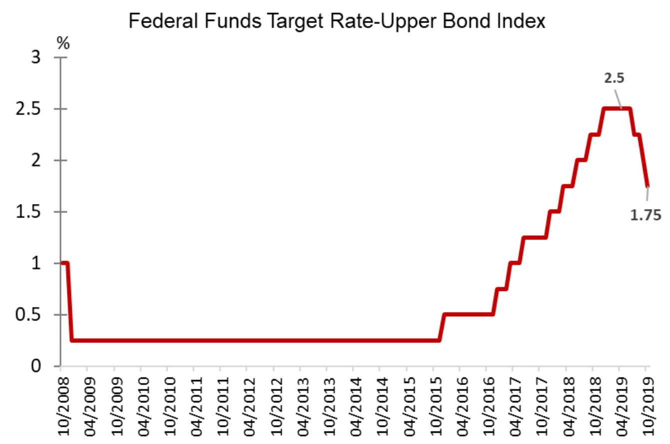
Figure 1: FOMC policy statement comparison (Sep 2019 and Oct 2019)

18-Sep-19	30-Oct-19
Although household spending has been rising at a strong pace, business fixed investment and exports have weakened.	Although household spending has been rising at a strong pace, business fixed investment and exports remain weak.
The committee devided to lower the target range for federal funds rate to 1.75%-2%.	The committee devided to lower the target range for federal funds rate to 1.5% to 1.75%.
The Committee will act as appropriate to sustain the expansion, with a strong labor market and inlfation near its symmetric 2% objective.	(deleted)
Voting against the action were James Bullard, who preferred at this meeting to lower the target range for the federal funds rate to 1.5 to 1.75 percent; and Esther L. George and Eric S. Rosengren, who preferred to maintain the target range at 2 percent to 2.25 percent.	Voting for the monetary policy action (included) James Bullard. Voting against the action were Esther L. George and Eric S. Rosengren, who preferred to maintain the target range at 1.75 percent to 2 percent.

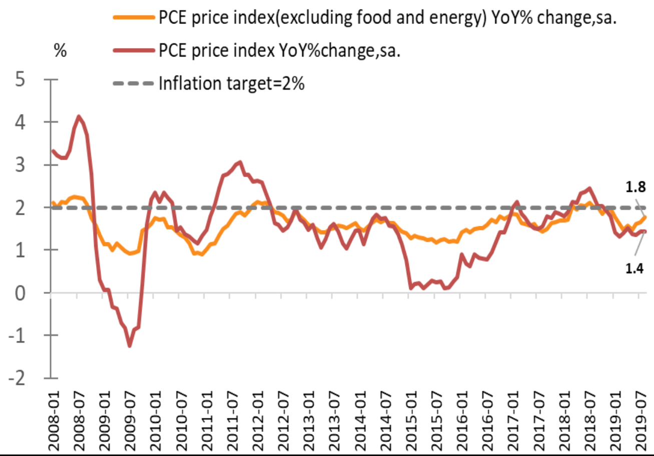
Source: US Fed, CMBIS

Figure 2: Fed has cut its policy rates by three times since Jul 2019



Source: Bloomberg, CMBIS

Figure 3: US inflation continued to run below the goal of 2%



Source: US FRED, CMBIS

Figure 4: Economic projections by Fed board members (as of the most recent projection)

Variable	Time of FOMC meetings	2019	2020	2021	2022	Longer run
Change in real GDP	2019-09	2.2	2.0	1.9	1.8	1.9
	2019-06	2.1	2.0	1.8	-	1.9
	2019-03	2.1	1.9	1.8	-	1.9
	2018-12	2.3	2.0	1.8	-	1.9
Unemployment rate	2019-09	3.7	3.7	3.8	3.9	4.2
	2019-06	3.6	3.7	3.8		4.2
	2019-03	3.7	3.8	3.9		4.3
	2018-12	3.5	3.6	3.8		4.4
PCE inflation	2019-09	1.5	1.9	2.0	2.0	2.0
	2019-06	1.5	1.9	2.0		2.0
	2019-03	1.8	2.0	2.0		2.0
	2018-12	1.9	2.1	2.1		2.0
Core PCE inflation	2019-09	1.8	1.9	2.0	2.0	-
	2019-06	1.8	1.9	2.0		-
	2019-03	2.0	2.0	2.0		-
	2018-12	2.0	2.0	2.0		-
Federal funds rate	2019-09	1.9	1.9	2.1	2.4	2.5
	2019-06	2.4	2.1	2.4		2.5
	2019-03	2.4	2.6	2.6		2.8
	2018-12	2.9	3.1	3.1		2.8

Source: US Fed, CMBIS (Data in red has moved up; data in green has dropped)

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