Fed “handcuffed” by markets

Review on Powell’s testimony to Congress in Jul 2019

SUMMARY. On Jul 10, US Federal Reserve Chairman Jerome Powell attended the US Congressional hearing to present the Fed’s semiannual monetary policy report and expressed Fed’s views on the US economy and monetary policy, emphasizing that trade tensions and global economic slowdown have already been weighing on the US economy and outlook. Powell's dovish remarks reaffirmed the market's expectations for a rate cut soon in Jul. The three major US stock indices leapt to records following Powell’s comments. Our views on Powell’s testimonial highlights and policy implications are as follows:

- **Powell’s judgment on economic situation and outlook sent strong dovish signals.** Powell believed that the job market remained healthy, while he was concerned about “a risk that weak inflation will be even more persistent than we currently anticipate”. In addition, Powell also stressed on the crosscurrents such as trade friction and global recession. Apparently, Powell’s view on economic fundamentals has become more cautious. He highlighted that the growth rate of US GDP in 1Q19 was mainly driven by net exports and inventory, the momentum of which was not sustainable. In particular, the significant slowdown in business investment had led to a retreat in US economic growth in 2Q19.

- **Fed’s monetary policy stance has further shifted.** During his testimony, Powell reviewed Fed's monetary policy stance in 1H19. Staying “patient” was consistently emphasized at FOMC meetings in Jan, Mar, and May. Since late May, the 17-member Fed policymaking committee reassessed the US economy and shifted its stance from “being patient” to “closely monitor” at the Jun meeting. FOMC split over whether to cut rates this year, with eight of them seeing the need for a rate cut (among which seven favored two cuts this year), another eight pointing to no change, and one opting for a rate increase. At the hearing, Powell made dovish remarks on behalf of the FOMC (as he said "my colleagues and I"), noting the divided Fed was coming to a kind of consensus as many of those once against rate cuts were now open to the cut option.

- **The Fed was “handcuffed” by the market.** If the Fed starts the rate-cut cycle in Jul, it will be a decision based on “uncertainties of the economic outlook”, rather than the actual economic conditions. In other words, it will be a precautionary interest rate cut. We believe that the market's expectation for Fed rate cuts has gone too high. In fact, the concerns of trade friction, global economic slowdown and weak inflation raised by Powell were nothing new. Though facing a similar environment at the end of last year, what the Fed hinted at that time was a continued rate hike.

  The reason behind the Fed’s dramatic shift within half a year was highly attributable to market sentiment and Trump’s intervention. Since 2Q19, the risk appetite of the global financial market has been severely affected by the economic slowdown and trade friction, resulting in mounting market expectations of rate cuts. With US stock market at record highs, it is hard for the Fed to work against the market. If the Fed’s monetary policy “disappoints” the market, it is likely to cause market shocks and bring extra risks, as well as inducing more relentless intervention by Trump.

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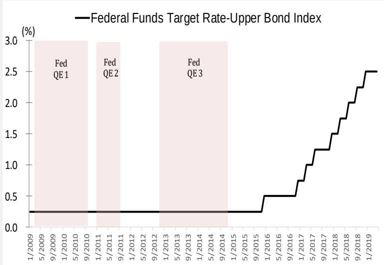
US federal funds targeted rate (upper)



Source: US Fed, CMBIS

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- **The independence of the Fed has been challenged.** Since last year, Trump has broken with the long-established presidential convention of abstaining from criticizing the Fed. He repeatedly attacked the Fed's decision in raising interest rates, claiming that the Fed's interest rate hike last year had crippled the US economy, and kept urging the Fed to cut rates as soon as possible. Trump maintained that he had the authority to fire Fed Chairman Powell. Powell made clear at the hearing that he would not resign if President Trump asked him so. However, Trump can still influence the Fed's stance through personnel arrangements. Recently, Trump intends to nominate two dovish economists who support interest rate cuts as Fed governors, and the removal of the Turkish central bank governor has also increased pressure on the Fed. Market and political pressure are undoubtedly "double constraints" for the Fed now.

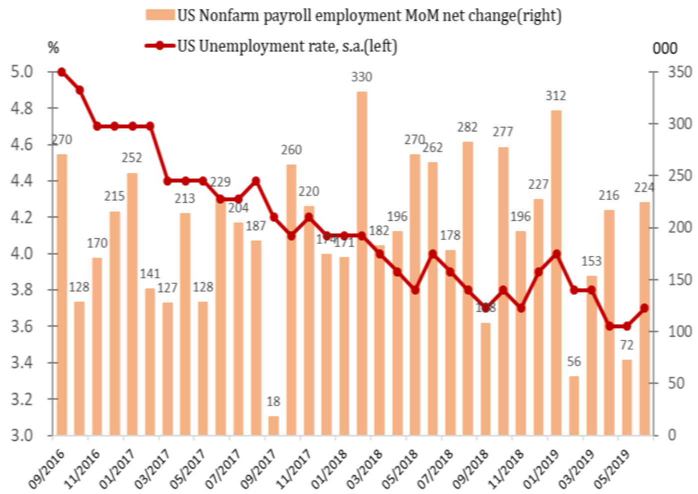
- **Conclusion: "Precautionary interest rate cut" possible in Jul.** Taking into account the latest remarks from the Jul hearing, we continue to expect the Fed to cut rates 1-2 times in the second half of this year, each time with 25bp. The dovish signals sent out by Powell can be regarded as "expectation management" before the Jul meeting, so the probability of a 25bp cut in Jul is high and a new rate cut cycle is likely to start, but the possibility of a direct 50bp cut is extremely low. On this basis, the Fed is expected to cut rate once more in 4Q19. In addition, we see the Fed's balance sheet reduction to end earlier than planned. However, as mentioned above, the current financial market has been overreacting and expecting too much on rate cuts, as Jul rate cut has been fully priced in. What is more worth paying attention to is the risk of correction triggered if the Fed's monetary policy falls short of market expectations. To China, the Fed's rate cut will weaken the support for US dollar and expand room for China's policy adjustment.

Figure 1: Changes of economic projections by Fed board members

Variable	Time of FOMC meetings	2019	2020	2021	Longer run
Change in real GDP	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
	2018-09	2.5	2.0	1.8	1.8
Unemployment rate	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
	2018-09	3.5	3.5	3.7	4.5
PCE inflation	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
	2018-09	2.0	2.1	2.1	2.0
Core PCE inflation	2019-06	1.8	1.9	2.0	-
	2019-03	2.0	2.0	2.0	-
	2018-12	2.0	2.0	2.0	-
	2018-09	2.1	2.1	2.1	-
Federal funds rate	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
	2018-09	3.1	3.4	3.4	3.0

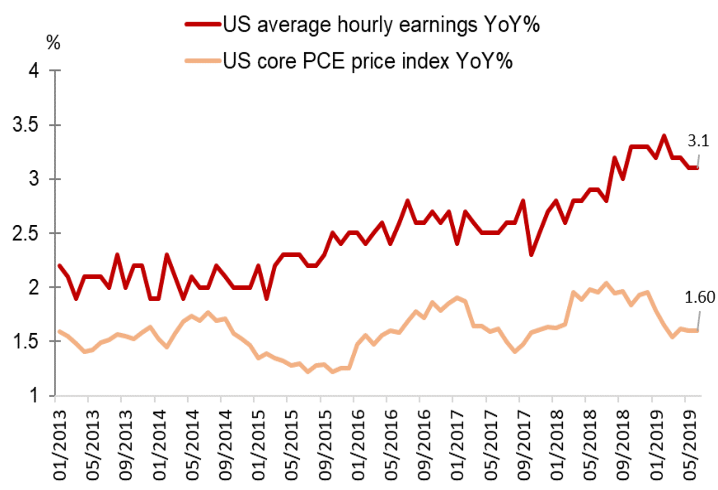
Source: US Fed, CMB Research Institute, CMBIS (Data in red has moved up; data in green has dropped)

Figure 2: US job market remains healthy



Source: CEIC, CMBIS

Figure 3: US core inflation has been declining in 1H19



Source: CEIC,CMBIS

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