Central Bank Watch

Interpret Fed's mixed signals after the rate cut and QE hint

On 18 Sep, US Fed announced to lower federal funds rate again by 25bp to 1.75-2%, following its first rate cut of 25bp in Jul, in line with expectations. The rate cut remained an "insurance cut" to sustain expansion and counter risks. Fed officials were further split over the decision and the outlook for more rate cuts. Fed Chairman Powell also hinted the resumption of an earlier-than-expected growth of balance sheet. We give an analysis in this report on the probability of continued rate cuts and the return of QE.

- **Fed expressed confidence about US economic outlook.** Fed's Sep economic forecast showed its growing confidence in economic growth for the next three years. Its forecast for GDP growth in 2019 increases by 0.1pct to 2.2%. Fed described household spending as "rising at a strong pace", but turned negative on business investment and US exports, both demonstrating the negative impact of trade tensions on US economy.

- **Analysis of the split over policy outlook:** Divisions deepened between officials over future path for monetary policy, but the stance of each individual voting member remained unclear, complicating the future policy outlook. On the face of it, the divergence of views widened among the officials. On the one hand, three out of ten voters dissented over the decision to cut rates. On the other hand, FOMC committee became more divided as seven of 17 officials penciled in one more rate cut this year, the other 10 split evenly between those who believed the new level of rates should be appropriate to maintain through the rest of 2019 and those who thought rates should be raised to Jul's level. However, it is worth noting that not all participants can vote. Among the 17 officials, only 10 of them have voting right over federal funds rate this year. Therefore, it is possible that majority of voters will be in favor of further rate cuts. As such, the probability of one more cut in 4Q19 still remains.

- **Future monetary policy to be decided on meeting-by-meeting basis.** Whether the "mid-cycle adjustment" has come to an end depends on two dimensions, in our view. 1) Economic data: As the Fed reiterated the "data-dependent" approach, it will attach more importance to economic data in deciding monetary policy. In case of improving economic data, the probability of further rate cuts will drop. 2) Risks: If good progress is made in China-US future trade talks, the need for risk management as well as political pressure the Fed faces will be significantly alleviated, calling an end to current round of rate cut. Currently, the downward trajectory of US economy and China-US trade outlook remain uncertain. Against the backdrop, one more cut in 4Q19 or 1Q20 (25bp) is still likely.

FOMC policy statement comparison between Jul and Sep 2019

2019 Jul	2019 Sep
Although growth of household spending has picked up from earlier in the year, growth of business fixed investment has been soft.	Although household spending has been rising at a strong pace, business fixed investment and exports have weakened.
The Committee will conclude the reduction of its aggregate securities holdings in the System Open Market Account in August, two months earlier than previously indicated.	(deleted)
Voting against the action were Esther L. George and Eric S. Rosengren, who preferred at this meeting to maintain the target range for the federal funds rate at 2-1/4 to 2-1/2 percent.	Voting against the action were James Bullard, who preferred at this meeting to lower the target range for the federal funds rate to 1-1/2 to 1-3/4 percent; and Esther L. George and Eric S. Rosengren, who preferred to maintain the target range at 2 percent to 2-1/4 percent.

Sources: Fed, CMBIS

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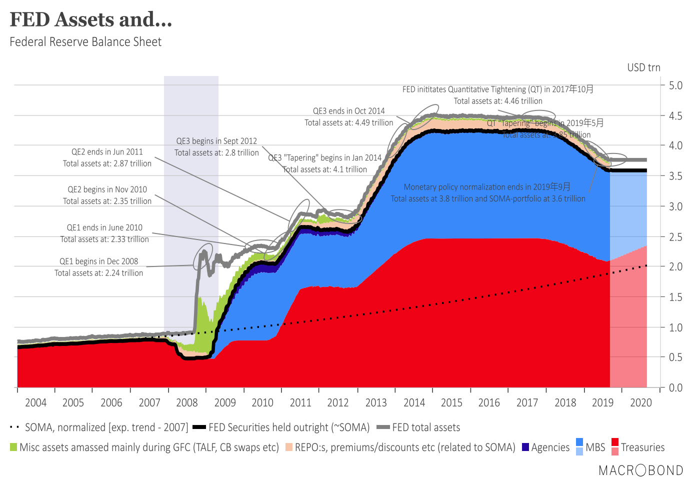
- **Powell hinted "organic growth of balance sheet" but did not consider negative interest rates.** Powell hinted in the meeting that the Fed may have to resume the organic growth of balance sheet. His statement had triggered a rise in US stocks and fall in US dollar immediately. The room for an interest rate level reaching Zero Lower Bound still exists, and Powell's reiteration of "balance sheet growth" was likely aiming to "rectify" the scale of commercial banks' reserves and the liquidity of commercial banks rather than to stimulate the economy. The short-term funds in the US money market tightened this week, while the short-term loan interest rate soared. The New York Federal Reserve thus had to carry out its first overnight repo operation in 10 years. During 17-19 Sep, it has released a total short-term liquidity of more than USD 200 bn. The Fed also decided to cut the interest rate on excess reserve (IOER) and the overnight reverse repo rate (ON RRP) at the Sep meeting. Powell did not think the Fed would use negative interest rate policy prior to other policy tools.

Figure 1：Changes of economic projections by Fed board members

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

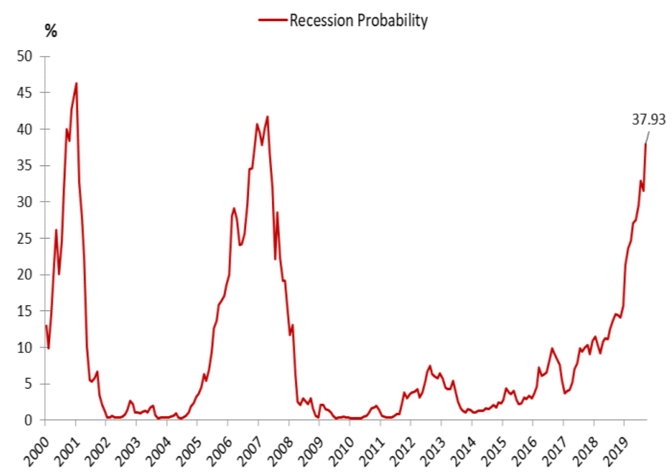
Source: US Fed, CMBIS (Data in red has moved up; data in green has dropped)

Figure 2: Fed's balance sheet



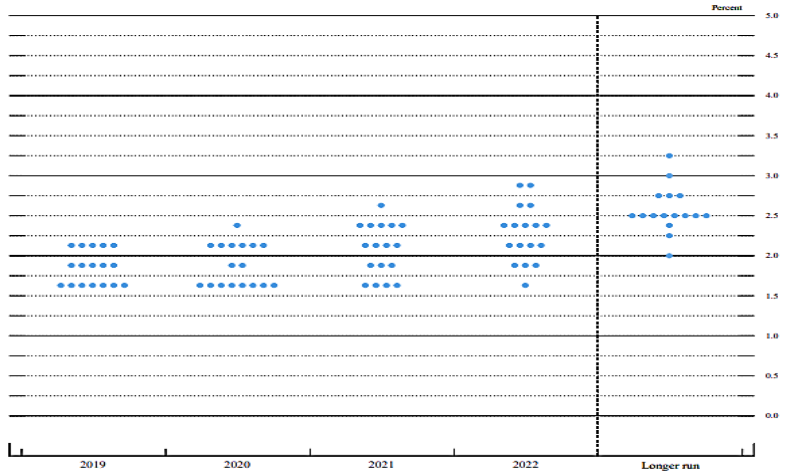
Source: Macrobond, CMBIS

Figure 3: US economic recession probability



Source: New York Fed, CMBIS

Figure 4：FOMC dot plot (Sep 2019)



Source: US Fed

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