Insights

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Tame Inflation Affords Fed Room to Cut in September

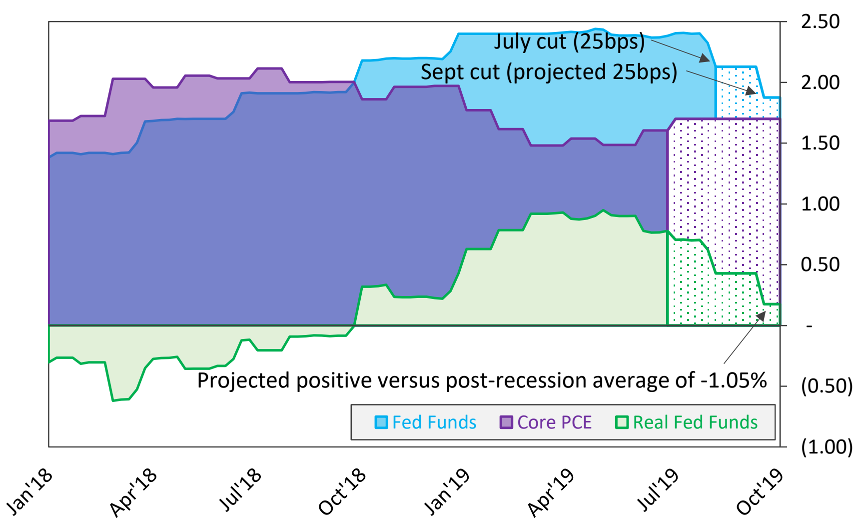
Unexpected escalation followed by sudden de-escalation of trade tensions has resulted in whipsawing risk asset returns and volatility. However, with each iteration of market distress followed by market calm, the continued rally in risk-free assets reveals mounting concerns over global growth that cannot be easily resolved via tweet. Weakening sentiment as evidenced by global central banks' dovish actions and the recent inversion in the 2s10s curve is likely to force the Fed's hand to cut interest rates by another 25 bps in September.

The messaging accompanying a September rate cut will be crucial as the Fed has seemingly lost all credibility after raising rates four times last year only to reverse course in July. If the Fed signals that their July cut did not account for weaker second quarter economic data from Germany and China, which would have reflected activity before Trump's early August escalation in trade tensions, then their ability to forecast economic trends and set appropriate policy responses will be called into question. If the Fed opts for another cut based on a "mid-cycle adjustment" stance, it will be another sign of capitulation to market forces. Moreover, should the Fed fail to concede to more cuts by the end of the year in an attempt to maintain the allure of independence, market sentiment will sour even more as it will be perceived that the Fed is turning a blind eye to the "true" state of the economy. Both these scenarios would serve as impetus for lower treasury rates.

The Fed is in an unenviable position, and increased disclosure and dialog with market participants following the financial crisis has only diluted the reality of how inherently difficult it is to distill economic uncertainties and crosscurrents into discrete decisions: cut, hold or hike.

Fortunately, the risk of overheating the U.S. economy through looser monetary policy appears low for now. The latest consumer price index data indicated that inflation continues to remain tame which affords the Fed room to reverse tighter monetary policy. While policy decisions will take time to ripple through the economy and show up in data as pointed out by Fed officials in recent weeks, secular forces including technology, globalization, and demographics will continue to be drivers for muted inflation pressures. A recent trend of excess manufacturing capacity and a drop in manufacturing worker hours further limits upside risk for inflation. The preferred measure of inflation for determining Fed policy decisions, the price index for personal consumption expenditure (PCE), will be released at the end of the month. The Fed is currently projecting core PCE to end the year at 1.8% compared to market consensus of 1.7%.

Tame inflation provides room to cut, but maintaining a positive real fed funds rate would indicate that is U.S. economy not yet in need of ultra-accommodative policy.



Source: Federal Reserve, BEA, Clearwater Advisors