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MARKET FOCUS TURNS TO A FED RATE CUT AS SOON AS DECEMBER

Transcript

Bill Emmons: Hi. I'm Bill Emmons and today is Friday, May 3. I'd like to talk about the FOMC meeting that took place this week. The key takeaways include the somewhat weaker economic outlook signaled by the FOMC pointing to slower consumer and business spending growth in the first quarter and inflation running below two percent. The Fed funds target range remains unchanged at two-and-a-quarter to two-and-a-half percent, but the Fed will reduce the interest rate on required and excess reserves by five basis points to 2.35 percent. And the Fed reaffirmed its plans to begin tapering the runoff of the securities portfolio. The shrinkage of the portfolio will end at the end of September. As you recall, after the last meeting in March investors had already started looking for interest rate cuts. And as of the last meeting, the probability of a cut early next year was still under 50 percent. But after this meeting, financial markets are signaling that the Fed will likely cut by December of this year.

So why are investors expecting a Fed rate cut by the end of this year? Chairman Powell did not signal whether the next move would be up or down. But markets seemed to be focusing more on the downside risks. The chairman did mention again international risks and he pointed to those main drivers of the US economy, consumers and businesses, as slowing a bit, even though the first quarter GDP number was strong. Also, inflation is running noticeably below two percent and there are some indicators that inflation expectations have slipped a little bit. So let me give you a little bit more detail on those points.

The top line GDP growth number in the first quarter was 3.2 percent. But underneath that, the two probably most important factors, consumers and business fixed investment, continued the slowdown which has been going on for the last several quarters. Inflation also is running below two percent. And it's really remarkable that over virtually any forecast or any horizon over the last 25 years, inflation has come in below two percent. That is, at an annualized rate, it was only .6 percent in the first quarter of this year and then going back a year, it was only 1.4 percent. And then as you look further and further into the past, the annualized inflation rates have been under two percent. A lot of the commentary after the meeting suggested that the Chairman, or possibly the FOMC generally, needs to grapple a little bit more explicitly with why inflation continues to run below the two percent target.

Inflation expectations may have declined a little bit. Consumers' inflation expectations taken from the University of Michigan survey drifted down a little bit over the last several years and most recently also seemed to be slipping a little bit. The blue dash line here shows the implied inflation compensation from treasury securities. So this is a measure of investors' inflation expectations. And it also has been a bit under two percent for most of the last several years. And as you can see, actual inflation has only tipped above two percent very briefly.

So as we've talked about in the past, the medium and longer term yields have come down significantly, flattening the yield curve. And that has continued through this meeting. Looking a little bit more closely, all of the yields from one year actually through seven years are now below the three-month treasury yield. So at all those maturities the yield curve remains inverted. So I think the implications for banks include the general theme that the economy is slowing and inflation is running below target. The flat yield curve warrants concern for the outlook because it has been a very reliable predictor in the past of slowdowns and outright recessions.

The financial markets are expecting a 25 basis point Fed rate cut at the December meeting, and additional rate cuts seem to be priced into financial markets in 2020.

So I think what we should expect is the Fed's balance sheet runoff to be tapered starting this month with that process ending by September. The FOMC has not signaled whether the next rate move will be up or down, but markets clearly expect Fed cuts to begin possibly as early as December. So I think bankers should be prepared for market volatility if incoming data or Fed signaling change this outlook.

Thanks for listening and we'll see you next time.

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