



August 2, 2019

**FOMC CUTS FED-FUNDS
TARGET RANGE 25 BASIS POINTS;
FIRST CUT IN 10+ YEARS**

Transcript

Bill Emmons: Hi. I'm Bill Emmons and today is Friday, August 2nd. I'd like to talk about the FOMC meeting that took place on July 30th and 31st, at which the committee cut its target range for the Fed funds by a quarter point. This is the first cut in over ten years. So the main takeaways include the fact that the FOMC signaled a relatively healthy economic outlook, even though it's concerned about inflation running a bit below its 2 percent target. The Fed Fund's target range was cut by 25 basis points to a range from 2 percent to 2 ¼ percent, and reduced the rate paid on required and excess reserves to 2.1 percent. The last time the Fed cut rates was in December of 2008 in the depths of the financial crisis.

The FOMC also announced that it would immediately cease the balance sheet runoff which previously had been scheduled to stop in September. It's also notable that two FOMC members dissented at this meeting: Presidents Esther George of the Kansas City Fed and Eric Rosengren of the Boston Fed. They both preferred no rate change at this point.

So this 25-basis point cut is relatively small compared to the very large movement in market interest rates we've seen over the last few months on the order of a 125-basis point drop in the two-year yield, which looks at the path of rates going forward.

On the announcement, the dollar strengthened, and commodity prices declined. These are also indicators that markets perceived this as a somewhat more hawkish outcome to the meeting than they had expected. So the range of expectations prior to the meeting was that there would be at least three cuts this year. In fact, according to market probabilities, there was about a 62 percent chance of at least three cuts by early next year. After the meeting, those probabilities shifted a little bit. So now there's closer to a 50/50 chance that we'll get those three cuts this year.

It was also notable just before the meeting that the first look at second quarter GDP came out. The peak in growth in the most recent period appears to have been in the middle of 2018. This is when we hit about 3.2 percent on year-over-year real GDP growth. The last year has seen notable slowing, so we're now down to about 2.3 percent year-over-year growth. If you look at the components of GDP growth, those that have slowed the most include consumer spending, which is by far the largest component, and notably, net exports. So the trade war does appear to be showing up in weaker trade, a lower contribution to growth. If you look at the private sector -- that's the consumption, investment, and net exports -- that has slowed down significantly from about a 2.9 percent to a 1.9 percent rate over the last year.

Data that just came out this week include ISM indexes. These are sentiment indicators for manufacturing, and both for the U.S. as a whole and for the Chicago area, which is closer to our interests, showed considerable weakness. And if you look a little bit more closely, you can see that, at least for the Chicago area, those readings are consistent with contraction in manufacturing. For the U.S., it's very close to that cutoff of about 50.

So why did financial markets react so negatively? Chairman Powell described the rate cut as a mid-cycle adjustment, not the beginning of an extended series of cuts. So reaction may reflect confusion about the Fed's



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economic outlook and monetary strategy. If, on the one hand, the Fed thinks the economy is strong, then why cut rates at this point? Clearly, inflation expectations are a concern. Some market participants don't think those were explained well enough. Investors, on the other hand, may be a little bit more pessimistic about the economy, putting some probability on a recession within the next year. I think it's also important to note that the two FOMC dissenters suggest that there will be resistance to future rate cuts.

So the implications for banks include an optimistic outlook for the economy by the FOMC. However, as we've talked in the past, evidence is accumulating that the economy is slowing, and inflation continues to run below target. There's some evidence from this reaction to the meeting that financial markets and the Fed remain somewhat out of synch. And I think it is worth noting too that St. Louis Fed President James Bullard will continue to be a thought leader and will receive a lot of attention in his public comments.

So I think what we should expect one or two more rate cuts this year of a quarter-point each. The economic uncertainty and market volatility appear to be at a higher level and probably will stay that way for some time. The yield curve also remains inverted. We've seen slowdowns in housing, manufacturing and trade, and all of these suggest the economy, in fact, could weaken further this year.

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

(END OF RECORDING)