



November 7, 2019

Third Rate Cut Could Be The Last For This Year-And This Cycle?

Transcript

Bill Emmons: Hi, I'm Bill Emmons and today is November 7th. I'd like to talk about last week's FOMC meeting. The FOMC made its third rate cut of the year. And it could be the last for this year according to financial markets, or possibly for this cycle if we can successfully extend this expansion.

So, some important takeaways from the meeting included a relatively favorable economic outlook driven again primarily by household spending. Inflation remains a bit below target, but not of any great concern to the FOMC. The Fed Fund's target range was cut by a quarter point to a range of 1½ to 1¾ percent. The Fed also reduced the interest rate paid on required and excess reserves to 1.55 percent. And the Fed will continue money market interventions by making large purchases of T-bills in the coming months, conducting overnight and term repos. Both of those operations will provide reserves to the banking system. And it will continue, as it has in the past, conducting reverse RPs at 1.45 percent, which actually drains reserves.

So, it's a fairly complicated set of interactions the Fed now is undertaking in the money markets. Two FOMC members dissented from this decision. Presidents Rosengren and George preferred no change at this meeting.

In the press conference after the meeting, Chairman Powell cited global factors again, and what he termed "buying insurance" to extend the expansion. In particular, he said, "Today we decided to lower the interest rates for the third time this year. We took this step to help keep the U.S. economy strong in the face of global developments and to provide some insurance against ongoing risks. We believe that monetary policy is in a good place."

So, let's look at that idea of buying insurance. And I think what the chairman is talking about is the fact that the Fed has successfully in recent decades cut rates and extended the expansion by a number of years. So, if we look back over the last 35 years or so, which I think is the relevant period—this is the so-called great moderation—the Fed has begun cutting rates on seven occasions. And some of those have been successful insurance purchases to extend the expansion.

Back in 1984, the Fed had tried to preempt an increase in inflation, and once they felt that was successful, did cut rates again. And we had several years of growth after that. In 1989, the Fed cut but it was not able to expand the expansion any longer. We did enter a recession in 1990. In 1995, again, after having raised rates aggressively, the Fed cut by 75 basis points and was able to extend the expansion. And then just a few years later, at the time of the Asian financial crisis in 1997 and 1998, the Fed, again, cut rates 75 basis points and appeared to extend the expansion.

The next round of cuts came in 2000–2001, which was not able to fend off the recession, although that was a very mild recession. Then in 2007, the Fed cut rates but was not able to prevent the economy going into a, this time, very severe recession.

And so, here we are in 2019 with, again, 75 basis points of cuts. And the question is, will this be a mid-cycle correction? That is, extending the expansion for a number of years. Or, is it actually the beginning of cuts that will end in a recession? Based on the last 30 years or so, I'd say these chances are about 50/50. That this, in fact, will turn out to be a mid-cycle correction.



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If it is successful, this would be the lowest unemployment rate at which this takes place. Now, that's important because the idea is by extending the expansion, we can continue with a strong job market and probably push the unemployment rate a little bit lower. If it goes much lower than it is today at 3.6 percent, that would be, of course, very, very low in historical terms.

So, looking at the financial markets, now, I think there is more consensus for the first time in some time. The FOMC and the markets appear to be on the same page here. Investors are putting the chance of another rate cut this year at only about one in four. Looking out though into next year, there's a little bit of divergence. The Fed would like to say that we're done with the cutting cycle at this point. Investors, on the other hand, put about a two-thirds probability on at least one more cut sometime this year, but more likely, next year.

So, the implications for banks, I think the FOMC still believes the economy is in good shape, driven primarily by the strong job market and consumer spending. As long as those continue, the economy will grow. Inflation remains below the FOMC's target. And, of course, interest rates are historically low.

I think a little bit different nuance this time, the FOMC has signaled that future rate increases would require the emergence of a significant inflation threat. In other words, the hurdle to increasing rates is pretty significant at this point.

So, what should we expect? The FOMC has signaled an indefinite pause in the rate-cutting cycle. Now, of course, that's similar to the message that we've been hearing for some time, but it now appears the markets believe it. The Fed's attention, I think, maybe shifted toward conditions in the money markets. As I mentioned, the Fed is involved in new ways in the money markets that we haven't seen for a number of years. And, of course, we're in the midst at the Fed of rethinking our overall monetary policy strategy, including communications with the markets and investors.

So, based on the experience of the last three decades or so, I'd say the chances of this being, in fact, a successful mid-cycle correction are about 50/50. But on the other hand, that means it is also possible by that 50/50 margin that this could be the beginning of rate cuts that are leading to a recession.

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

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