# Hitting The Gas

Unusual. Unconventional. Unprecedented. Each of these terms was used to describe the Federal Reserve's actions in the recent financial crisis of 2008-2009. The Fed decreased rates to its lowest feasible range—0%-0.25%—and held rates steady for the longest period in U.S. central banking history—7 years. The central bank also undertook large-scale asset purchases in order to improve liquidity in credit markets, lower long-term interest rates, and stimulate economic activity. The balance sheet peaked at $4.5 trillion in January 2015, when the Fed ended its asset purchase program. Deeper recessions often precede stronger recoveries, and the end of the Global Financial Crisis and subsequent monetary policy response led to what continues to be the longest economic expansion on record, going on 122 consecutive months.[1]

Fast-forward to today. The balance sheet has dwindled to $3.8 trillion—a far cry from the $800 billion pre-2008. The Fed will end its balance sheet runoff in August, two months earlier than previously indicated. The period of rate increases from December 2015-2018 is now replaced with the first rate cut since 2008. Since the 1970's, there have been nine rate-hiking cycles and nine rate-cutting cycles. With the Fed's decision to cut rates at its July meeting, the potential inception of another rate-cutting cycle begins. Why the shift from rate-hiking to rate-cutting? And what does this mean for the economy and markets?

## Dual Mandate Status Update

The Federal Reserve's dual mandate is to deliver 1) maximum employment and 2) stable prices. If we were to score the Fed on this mandate, it would safely receive an "A-." The unemployment rate is at its lowest point in 50 years. The broadest measure of unemployment, which includes all marginally attached, part-time for economic reasons, and discouraged workers, is just

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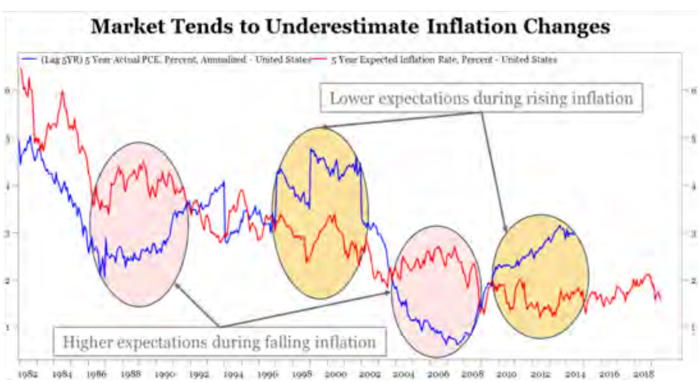
0.2% off all-time lows in 2000. The four-week moving average of unemployment claims is also at its lowest point in 50 years.

Concerning inflation, prices have remained stable, albeit slightly below the Fed's 2% target established by the Federal Open Market Committee (FOMC) in January 2012. The Fed professes a symmetric 2% target and, depending on the measure, inflation is close but not quite there, docking our score from an "A" to an "A-." The consumer price inflation (CPI) is hovering around 2% over the past five years, indicating a stabilization in inflation toward target in the latter half of a long economic recovery. However, the Fed's preferred measure of inflation, the personal consumption expenditure (PCE), remains around 1.6%.[2] If you trim the most extreme price changes, the "trimmed mean" measure of PCE measures 2%. On the contrary, the market's inflation expectation as indicated by the 5-year and 10-year forward inflation expectation is below 2%.[3] The Fed's biggest concern is not current measures of inflation but inflation expectations. Ironically, the market often under or over estimates inflation changes (see Figure 1).

Figure 1




*Source: U.S. Bereau of Economic Analysis; Federal Reserve Bank of Cleveland; FactSet; Highland Associates*

## Global Growth Divergences

Powell, in his July press conference, referenced other times when the Fed has cut rates in the middle of a cycle, calling the latest FOMC decision a risk management or insurance cut. In reviewing the Fed's minutes and transcripts, we find notable similarities and differences in two different periods of rate hiking cycle pauses: 1995 and 1998 (see Figure 2).

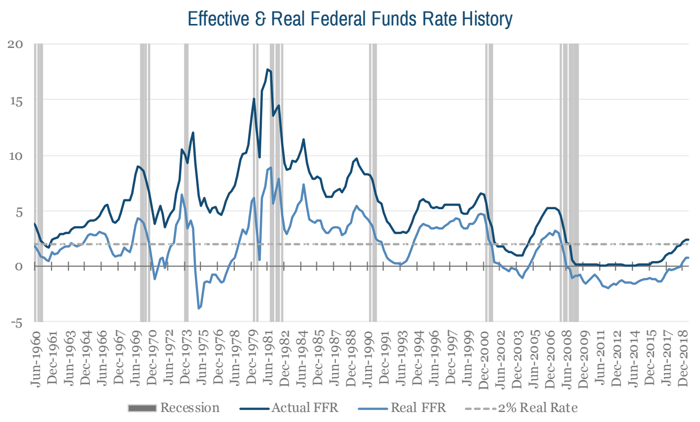
Figure 2

| Date | Inflation | Unemployment | Real Rates Prior to Cut | Months Until Next Rate Hike | Next 12 Months Performance S&P 500 | Reason For Cut |
|---|---|---|---|---|---|---|
| Jul - 1995 | 2.3% | 5.6% | 3.8% | 21 Months | 21.5% | • Receding inflationary pressures<br>• Economic growth slowing more than expected<br>• Market expectations for monetary policy easing<br>• "insurance policy" |
| Sep-1998 | 0.8% | 4.5% | 4.3% | 9 Months | 22.5% | • Asian currency crisis<br>• Sovereign defaults<br>• "Insurance policy" |
| Jul-2019 | 1.4% | 3.7% | 0.8% | — | — | • uncertainty from trade tensions<br>• concern over global growth<br>• muted inflationary pressures<br>• Powell referenced "mid-cycle policy adjustment" and "insure against downside risks" |

*Source: Highland Associates; Federal Reserve; FactSet*

These episodes are examples of times when the Fed found it prudent to make "insurance" cuts. Greenspan, who was at the helm of the Fed in the '90s, recently backed the Fed's July policy decision recalling the decision to preemptively cut rates in '95 and '98 in order to insure against "certain small probability events" that could be dangerous for the economy, saying "it pays to act to see if you can fend it off." We think today is most similar to 1995 for several reasons: there is no financial crisis or imbalance like in 1998; equity markets and credit spreads are stable; the market expects significant monetary policy easing; and the Fed is set to respond. Today differs in that unemployment and interest rates are much lower. Currently, real rates hover near 1% after spending just over a decade below 0%. We have never had a recession with real interest rates below 2% (see Figure 3). Could we have a period where the Fed cuts rates only to resume rate hikes when inflation risks grow and economic growth persists at or above capacity? Powell indicated a similar path based on other midcycle adjustments.

Figure 3




*Source: Federal Reserve*

## A Change in Policy

July's FOMC meeting decision to cut rates was communicated as in response to uncertainty in the global economic outlook and muted inflation pressures, but many question whether this was motivated by politics or fundamentals. President Trump has been a vocal critic of Powell and his committee's decisions, advocating for a rate cut. Trump started his Twitter campaign against Fed policy starting July 2018 after the third rate hike. The President criticized the Fed on four separate occasions in July. The latest critical tweet from July 29 reads, "The Fed has made all of the wrong moves. A small rate cut is not enough." Trump's comments prove a distraction but likely not a source of market confusion in the long run. The Federal Reserve chairmanship is safe from presidential firings. There is also a precedent set for disagreements between the President and the Fed in the Johnson and H.W. Bush administrations. But ultimately, "There is very little evidence that the Fed responds to short-term presidential efforts to micromanage its monetary policy activities," according to research by Dr. Irwin L. Morris. [4]

Ruling out political pressure, there are fundamental reasons why the Fed chose to cut. Slowing global growth and the uncertainty of the trade feud with China (and potentially Europe) drove the Fed to cut rates. Signs of slowing global momentum are indicated by contracting global PMIs. The overhang from the trade war has also reduced business fixed investment. The U.S. economy is currently slowing but growing. In order to avoid a protracted decline in growth, the Fed chose to act preemptively, taking an "insurance cut."

Additionally, the Fed hopes to address low market expectations for inflation. While historically we think of the Fed fighting high inflation, the Fed wants to avoid deflation because of the negative impact it has on consumer spending (consumers defer consumption as they expect prices to go down for discretionary or large-ticket type purchases), which makes up 70% of the U.S. GDP. Inflation also decreases the real value of debt, so without inflation, there is a real increase in debt burden that poses serious risk in an economic downturn as individuals and corporations struggle to repay. Finally, the Fed's tool kit to fight deflation is not as robust, and deflation would result in a higher real interest rate, undermining the Fed's intentions in raising and lowering interest rates (e.g., nominal fed funds rate = real fed funds rate + inflation). Recent research indicates that with rates not far from the 0% lower bound, the Fed should act to spur inflation above target in order to avoid declining long-term inflation expectations.[5] Higher inflation expectations reduce the effects of the zero lower bound on interest rates by giving the Fed more room for a policy response in a downturn via lower real rates.

## Implications

The 25 basis point interest rate cut is a clear indication that the Fed no longer thinks that inflation weakness is transitory and that slowing global growth momentum and trade uncertainty present a tail risk worth hedging. Despite stable (albeit slightly lower than the Fed wants) pricing and solid but slowing growth, the Fed has chosen instead to make an insurance cut. This achieves two objectives: 1) it signals to the markets that the Fed is set on avoiding a recession, and 2) the Fed is intent on increasing the market's inflation expectations. In addition, the Fed chose to reinforce its easing stance by ending its balance sheet runoff two months earlier than previously indicated.

The best description of the Fed's policy response is "sentiment stimulus." Like a car going up a steep hill, failing to give it enough gas causes the car to stall out, but applying a little extra pressure to the pedal increases the momentum to get over and keep going. This is what the Fed is trying to achieve—a stable and growing economy that doesn't stall out. Markets priced in the move prior to the meeting, and the Fed heard the markets' concerns—delivering monetary easing and proactively setting expectations. The Fed has historically "over-tightened," pushing the economy into recession, and this move tells the markets "not this time." This move was immediately dismissed by the markets, which declined on lack of a clear indication for future rate cuts. If you read the beloved children's book *If You Give a Mouse a Cookie*, you will know that he'll want a glass of milk. The markets are just as hungry, and giving them one rate cut is not enough.

However, unlike in 1995, the Fed is cutting from 2.5%, as opposed to 6% in 1995. There is far less of a rate cushion to work with in case of a real economic downturn. In a sustained economic downturn, the Fed has only 9 cuts it can make (in 25 basis point increments). Additionally, there is roughly $15 trillion in negative yielding sovereign debt that poses a new challenge to global central banking. The marginal benefit of a rate cut today is most likely lower than in the last rate-cutting cycle starting in 2007. That is why the timing of the Fed's response is important, given the limitations to policy responses today with globally low yields and large central bank balance sheets.

We are now watching closely what could cause the Fed to continue pushing down its target rate. Is the Fed seeking to support an expanding U.S. economy by staving off any global weakness from spreading here? Or, is there more serious economic weakness on the horizon that the markets are not heeding? These will be the important issues to weigh. If this is more than an insurance cut and the Fed does keep cutting, it will be because of significantly weakening economic fundamentals, and probability of a recession increases. In this case, the Fed will likely have less ammunition to stimulate economic activity and stoke inflation making a soft landing unlikely, which would be bad for risk assets.

Therefore, while markets will likely respond positively to rate cuts, we remain cautious with our eyes on the horizon, mindful of changes in key indicators. In light of the escalating trade feud between the U.S. and China, we are reminded of how swiftly unexpected policy shifts can change sentiment which can filter into the real economy. We are watching market indicators closely as widening credit spreads and weakening momentum smell the smoke before the fire. Powell rightly observed during the July press conference that responding to global trade tensions is fairly new for central bankers. Trade policy cannot be forecasted, like other important economic variables, but only responded to. The timeliness of the Fed's response indicates a higher probability of success of the Fed's policy intentions coming to fruition; however, the unexpected nature of trade policy has the Fed in a reactionary state.

Similar to the fourth quarter [**4Q18**], we remain at a crossroads: will markets ascend or abate? While we still see signs of a slowing yet growing U.S. economy (e.g., expansionary leading economic indicators, extremely low unemployment, and now easier monetary policy), the sudden shifting tides on the trade front from positive negotiations to more incendiary tactics has renewed market uncertainty. The Fed has a difficult balancing act ahead. The domestic economy continues to plug along while the rest of the world is still trying to navigate difficult waters. Yet, the prospects of trade negotiations have turned sour and threaten to unravel growth going forward. All the while, markets are turning volatile. For now, the Fed is easing which should benefit risk assets, so we maintain an overweight but acknowledge the path could be rockier going forward. We are also keeping a watchful eye on both fundamental and market indicators for any signs of further deterioration pointing us to a change in positioning.

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*1) https://www.clevelandfed.org/en/newsroom-and-events/publications/economic-commentary/2019-economic-commentaries/ec-201902-do-longer-expansions-lead-to-more-severe-recessions.aspx*

*2) CPI has historically run persistently higher than PCE. This can be attributed to differences in the basket of goods tracking for pricing changes. CPI is based on a survey of what households are buying, and PCE is based on surveys of what businesses are selling. There are other technical differences in the scope of what is covered in the basket and weights used.*

*3) Federal Reserve Bank of St. Louis, 5-Year, 5-Year Forward Inflation Expectation Rate [T5YIFR], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/T5YIFR, July 26, 2019.*

*4) https://www.marketwatch.com/story/the-history-of-presidential-fed-bashing-suggests-it-has-not-been-a-fruitful-strategy-2018-10-11*

*5) https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr877.pdf and https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr887.pdf*

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