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The Fed Serves Up Another Incremental Cut Amid "Disparate Perspectives"

By Ellen Gaske, PhD, CFA, Lead Economist G10 Economies, Global Macroeconomic Research Team, and Robert Tipp, CFA, Chief Investment Strategist and Head of Global Bonds

As expected, the Federal Reserve again nudged the Fed funds rate target down another 25 bps to 1.75%-2.00% at its meeting on September 18, 2019—its second 25 bp rate cut in consecutive meetings. However, in a sign of just how divided the Fed is over the appropriate policy stance, two FOMC members (Esther George and Eric Rosengren) again dissented in favor of keeping rates unchanged, while one (James Bullard) dissented in favor of a more aggressive 50 bp cut.

Overall, U.S. economic growth has been resilient, despite the waning effects of last year's fiscal stimulus, a weaker global economy, and a current impasse in U.S./China trade talks. Indeed, the Fed's median projection for GDP growth this year was raised slightly to 2.2%, followed by a 2.0% pace next year. While the labor market and household spending have remained strong, business investment and exports have weakened. And although PCE inflation has reaccelerated in recent months, it remains below 2% on a year-over year basis. All of this creates a backdrop for "difficult judgments, disparate perspectives," as Chairman Powell noted in his press conference.

The Fed's policy statement remained open-ended and non-committal about the likely path for policy going forward. Chairman Powell was careful not to label today's rate cut as a "mid-cycle adjustment" as he had at the Fed's previous meeting—a characterization that seemed to confuse the market and perhaps implied too much guidance about Fed policy going forward. As was the case in June, however, seven out of 17 Fed officials expect another rate cut by year-end, according to the Fed's updated dot plot. While not a majority of FOMC participants, it was apparently a majority of voting members, at least at this meeting.

If our outlook for U.S. economic growth (2.4% in 2019 and 1.9% in 2020) and inflation (close to 2% by year-end 2019) pan out, resistance by some Fed officials to further rate cuts going forward may increase. We think the risks are heavily skewed towards an additional rate cut later this year or early next year, however.

Addressing Repo Stress

Recent stress in the repo market—resulting in sharp spikes in overnight funding rates and an effective Fed funds rate that has breached the Fed's targeted upper limit at times—drove the Fed to undertake a number of measures to relieve the stress. Alongside the latest 25 bp cut in the Fed funds rate, the Fed once again adjusted the interest on excess reserves (IOER) rate (i.e., the rate it pays on bank reserves), cutting it 30 bps to 1.80%, only 5 bps above the lower end of the targeted band for the Fed funds rate and meant to encourage the Fed funds rate to trade lower as well.

The Fed has also begun conducting open market operations as needed to inject additional reserves temporarily into the banking system. And with its balance sheet tapering having ended in August, the Fed is now focused on when to end the roll-off of bank reserves, which are passively continuing to shrink as other non-reserve liabilities on the Fed's balance sheet (e.g., currency outstanding) increase at the expense of reserves.

"Good Enough" for the Markets

All said, the Fed's actions and signals were taken by the markets as "good enough," successfully balancing the markets' concerns. On the one hand, the FOMC acknowledged downside risks and funding pressures by cutting rates and adding liquidity. In terms of going forward, while the median dots were split between unchanged and lower, investors appear to be banking on the voters prevailing and acting if needed at future meetings, as they did today.

While the Treasury market may have cheered a more cautious economic assessment, it accepted the Fed's guardedly optimistic assessment, taking yields to modestly higher levels on the day after being lower earlier in the session. Risk markets, such as stocks and non-government spread products, improved somewhat, taking the Fed's confident assessment and willingness to further support the economy, again, as a "good enough" outcome.

Looking forward, markets appear likely to continue their current course with negative foreign rates keeping the U.S. yield curve a bit lower than it would be otherwise. And while risk markets would undoubtedly perform better with a more upbeat economic backdrop, the current configuration of modest growth and central bank support should leave markets set to outperform developed market government assets over the intermediate to long term. However, thanks to the low-growth/high-leverage/high-anxiety global backdrop, markets will remain subject to intermittent bouts of volatility, which could be extreme at times.

Source(s) of data (unless otherwise noted): PGIM Fixed Income as of September 18, 2019

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