EDGE RESEARCH INSIGHTS | June 2019

Fed Holds, Signals Cut(s)

Fed policymakers left the target federal funds range unchanged but the signal for more monetary policy accommodation strengthened. In contrast to the March announcement when no participants forecast a rate cut, seven of the 17 Federal Open Market Committee (FOMC) participants now forecast two rate cuts by year-end (25 basis points each). Despite their accommodative stance, Fed expectations continue to lag market-implied expectations. Federal funds futures priced in three rate cuts by year-end at the close of trading. In his press conference, Fed Chair Jerome Powell stressed the FOMC participants' preference to take a patient approach to rate policy, citing mixed signals in economic, business and household data.

Fed policymakers did not provide an update on their balance sheet reduction program, but Powell stated they are committed to adjusting their balance sheet to support their dual mandate. Among major developed economies, the size of the Federal Reserve's balance sheet relative to U.S. Gross Domestic Product (GDP) was just over 18 percent through May. By comparison, assets held on the Bank of England and European Central Banks' balance sheets were approximately 23 percent and 40 percent, respectively of each countries' GDP. The Bank of Japan is an outlier as total assets on its balance sheet represent nearly 103 percent of GDP. Fed policymakers have substantial "room" should they choose to leverage their balance sheet going forward.

Key Points:

- Although the unemployment rate remains anchored to 40-year lows, tight labor market conditions have not produced wage pressures sufficient to spur sustained inflation. Fed projections now forecast Personal Consumption Expenditures (PCE) inflation will be just 1.5 percent by year-end, substantially lower than their 1.8 percent forecast in March. Business fixed investment remains weak, however consumer spending accelerated in May. Given these mixed signals, FOMC participants opted to monitor incoming economic data. Market-based measures have already priced in one 25 basis point cut at the July 31 FOMC meeting. For now, weak economic data appeared to be good news for investors as the S&P 500 Index inched closer to its all-time high following the Fed decision.

- U.S. equities hovered near unchanged prior the FOMC announcement but ended the session 0.3 percent higher. Economic growth remains low but steady; however, the risk of slowing global growth and trade tensions could test the resiliency of that outlook. Fed policymakers' median forecast for the GDP growth was unchanged at 2.1 percent while inflation expectations fell for the second consecutive quarter. Crude oil prices remain below their trailing twelve-month peak set back in October, and sluggish real wage growth are weighing on official inflation statistics. In the absence of strong economic data, investors remain confident in the ability of global central banks to support slow, but positive, economic growth.

U.S. Treasury yields moved lower, but the two-year/10-year spread rose 2.5 basis points to 26.1 basis points since the prior week. At the close of trading, the spread between the 30-year bond and the effective federal funds rate was just 17 basis points. The inverted yield curve signals that monetary policy is too tight relative to economic conditions. As of the close of trading on Wednesday, Fed Fund futures had priced in over two rate cuts in 2019 and more than 3.5-25 basis point rate cuts by June 2020.

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