LPL RESEARCH

WEEKLY ECONOMIC COMMENTARY

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THE INAUGURAL RATE CUT

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KEY TAKEAWAYS

The Fed is expected to cut rates this week for the first time in 10 years.

We view any upcoming cut as a policy adjustment, not a response to significant economic weakness.

A rate cut could help boost consumption and sentiment and lead to even looser policy.

It could be a momentous week for U.S. monetary policy. The Federal Reserve (Fed) is expected to cut its policy interest rate for the first time in 10 years on July 31, the last day of its next policy meeting [Figure 1].

The Fed has strongly hinted toward a rate cut at this meeting, even prepping investors for this decision with a language shift at its June meeting. Still, this is uncharted territory for much of Wall Street, as well as the current set of Fed central bankers.

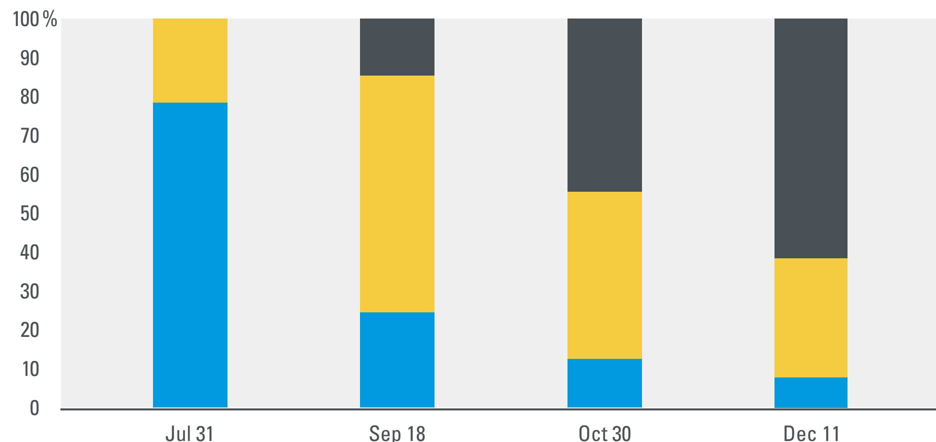
THE CUT ITSELF

There is a debate among investors about how much the Fed will adjust rates in its inaugural cut. Fed fund futures are pricing in an 80% chance of a 25 basis point (0.25%) cut and a 20% chance of a 50 basis point (0.50%) cut.

To us, this is more of a question of the Fed's intentions with this specific cut. We think the Fed will view the cut as a course correction, not as a decision to get ahead of an imminent recession. Economic data hasn't deteriorated

1 INVESTORS BRACE FOR A JULY RATE CUT

Implied Probabilities for Fed Funds Rate Changes



Source: LPL Research, Bloomberg 07/24/2019

A rate cut is a 25 basis point (0.25%) reduction from the current upper bound fed funds rate of 2.5%.

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enough to warrant a Fed rate cut, and there are still significant bright spots in an otherwise tepid environment. However, policy may be too tight for a weakened economy hampered by a drawn-out trade dispute.

Since 1990, the Fed has commonly cut rates by 25 basis points when adjusting policy in the middle of expansions, especially in the first rate cut after a series of rate hikes. That was the Fed's approach in July 1995 when policymakers instituted a series of rate cuts in response to fears of overtightening with few signs of economic distress. We see several parallels between that scenario and today's.

The Fed has historically reserved steeper rate cuts for dire economic situations. Since 1990, the Fed has implemented 19 cuts of 50 basis points or more. Only seven of those cuts happened in expansions, and six of those seven cuts were in the 12 months before or after a recession had started or ended. Of course, there's always a small chance of a looming recession, but we don't see signals of excess or weakness that typically lead to a downturn.

COMMUNICATING THE CUT

The Fed's commentary after the rate announcement could be as important as the rate decision itself. In his post-meeting press conference, Fed Chair Jerome Powell will have to deliver another delicate message to investors, who could interpret good news as bad news. Lately, Powell and other Fed speakers have hinted at the need to loosen policy, but they have leaned on largely positive commentary about the U.S. economy. Just last month, Powell said the U.S. economy is performing "reasonably well" with solid economic fundamentals. That could be a difficult dynamic to reconcile with looser policy. We suspect Powell and the Fed won't shy away from optimistic observations about the U.S. economy, but they will likely need to elaborate extensively on why a rate cut is happening right now. As always, markets will likely hang on Powell's every word, and missteps could trigger volatility.

Reducing the policy rate while maintaining sales of balance sheet assets could be another communication challenge. A July cut would run counter to the Fed's intentions with balance sheet sales, which are scheduled to end in October. There's a chance the Fed may end runoff sooner than expected to sync up its balance sheet and rate policy, and to help convey a unified push to loosen policy across the board.

WHAT HAPPENS NEXT?

Cutting rates now would help loosen financial conditions, although some of that impact has already been priced in. It's too soon to tell exactly how a lower policy rate will help boost economic growth in this environment, but we hope it will at least provide a lift to sentiment, which could translate into higher consumer and corporate spending.

A rate cut could also have implications for the future of monetary policy. The Fed doesn't put a definitive timeline on future policy changes, as we've noticed from policymakers' rhetoric over the past several years. Guaranteed policy changes would defy the Fed's promises of flexibility and data dependency.

One tool we use to understand Fed members' expectations is the "dot plot," a summary of policymakers' fed funds rate projections. As of June, the dot plot shows 8 of 17 Fed members expect at least one rate cut by the end of 2019 and even lower rates by the end of 2020. Unfortunately, we won't get an updated dot plot or economic projections at this meeting (unless the Fed unexpectedly releases updates), as the next updates are scheduled for September.

History shows that a Fed cut has led to a more long-term shift in policy strategy. Since 1990, the Fed has cut rates an average of five times in

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the 12 months after the first course correction in an expansion. After the July 1995 cut, the Fed reduced the policy rate two more times over the next 12 months (and five times before the end of 1998) before implementing another series of rate hikes.

We agree with the consensus (and Fed members) that more cuts are likely ahead, especially with no U.S.-China trade deal in sight.

CONCLUSION

We encourage investors to view a Fed rate cut as a pre-emptive measure rather than an indictment of the economic outlook. An "insurance" cut here would be prudent, as it could provide a buffer if uncertainty continues to weigh on growth and reduce the chances of a policy mistake or a rush to cut rates before a recession. We still see low odds of a near-term recession, as well as gross domestic product growth of 2.25–2.5% this year. ■

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