Macro & FICC Research

Central Bank Insights

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Fed delivered as promised – Fed Funds cut by 25bp

SEB Macro and FICC research

As expected Fed lowered the target range for the federal funds rate to 2.00-2.25% Also the fed decided to stop shrinking the balance sheet immediately which is 2 months earlier than previously indicated. The cut was widely expected by the market and economists. Feds Powell mentioned that the cut is an insurance policy to counter weaker growth, uncertainties, trade conflict and inflation but also a falling neutral interest rate. Powell also said that he saw the cut as a mid-cycle adjustment and that he does not predict a long series of rate cuts. Powell was however also clear that this should not be seen as a single cut.

Powell did not fully satisfy markets. US stocks fell and shorter US rates as well as the USD rose after the decision. Interestingly, however, the US 10 year yield fell signalling some distrust of the signalled policy.

We stick to our forecast that Feds dovish turn means even lower policy rate ahead and expect another rate cut before year end (in December). Market prices currently in at least one more 25bp cut in 2019 and a total of 3 before the end of 2020. There are a number of downside risks like the US-China trade war and inflation is stuck below target. More accommodative monetary policy will be used as an insurance premium and Fed is not expected to wait for economic data to disappoint before acting again.

As expected, the Fed delivered on its shift towards a more dovish monetary policy. The decision to lower the target range for the federal funds rate to 2.00 to 2.25% was widely expected by markets and economist. The market had it fully priced in and of the 86 economists surveyed by Bloomberg all but 12 expected the outcome (of the 12, 11 went for unchanged rate and 1 for a 50bp cut). Today's cut was the first in over a decade and the last time a cutting cycle was initiated was nearly 12 years ago in the wake of the financial crises.

At the June meeting Fed chair Powell had his first dissenter when Bullard wanted to cut rates. At today's meeting, the dissenting board members where from the opposite side and both Kansas City Feds Ester George and Boston's Eric Rosengren wanted to keep Fed Funds unchanged. Noteworthy is that Fed usually is unanimous when starting an easing cycle which was not the case today. The interest on excess reserves was lowered in line with the Fed Funds (from 2.35 to 2.10%). No new forecasts or dot-plots were presented at this meeting.

In the press release Fed are a bit more cautious on the economy compared to June and now for example states that the economy ''has (is in June) been rising at a moderate pace''. Fed also notes that the decision to cut Fed Funds is taken ''In light of the implications of global developments for the economic outlook as well as muted inflation pressure…''. Fed Chair Powell mentioned at the press conference weaknesses in manufacturing, both domestically but also internationally. Also falling neutral interest rate (making policy tighter without a cut) and also falling neutral unemployment rate as reasons for monetary easing.

Looking ahead we see a clear case for further easing of monetary policy. Lower policy rate is an insurance policy to make sure that growth continues, the labour market continues to improve and give inflation support.

We have pencilled in another cut in December this year, but depending on data it could happen earlier. Fed notes that it will continue to monitor the implications of incoming information and act so sustain the expansion taking into account both the labour market and inflation.

The bar was set high and a dovish decision was expected. Looking at initial market reactions, it seems that Fed and Powell provided somewhat of disappointment especially to equity markets as some market participants were expecting a 50bps cut.US equities fell heavily when the Q&A session started. S&P500 fell as much as 1.9% during the first hour after the decision. The reaction in US rates was more limited with the 2y USD OIS increasing by some 7bps after the Q&A, flattening the 2s10s curve. Following the same pattern EUR/USD fell 0.6 figures to trade around 1.1080 at the end of the Q&A session compared with 1.1140 just before the rate decision.