

May FOMC Minutes (and FedSpeak) Don't Yet Offer Cut Scenario

Andrew Husby*

The Minutes to the May 1st FOMC meeting yield no major surprises, and in any event were old news given the surprise flare-up in the U.S. China trade war. Growth risks there, and from some deterioration in Brexit scenarios over the last two weeks, will loom larger come the June meeting.

Powell Had Backing on Transitory Inflation Comments

On the inflation front, debate about the causes continues, but a modest surprise is that “many” saw recent inflation softness as likely transitory—that wasn’t just Powell shooting from the hip in the post-meeting presser.

The Minutes cite a lurch lower in apparel prices and financial services prices (the latter large but arithmetically oversold as a driver of headline inflation softness) as among the transitory factors.

(At 0.2% of the index, even the observed 5-6% reduction in the y/y rate of growth in financial services prices earlier this year accounts for a 0.01-0.02% drag on headline inflation, effectively imperceptible.)

Weighing What Happens to the Balance Sheet Longer Term

There was a staff presentation on what the Fed’s portfolio should look like over the long term, with two options discussed: (1) one roughly proportional to the maturity profile of outstanding Treasuries, and (2) a short-term portfolio of three years or less. “Many” noted the advantage of option 2, which would allow space for a maturity extension program (MEP) as a policy tool in the event of a future downturn.

The argument against that could be a higher term premium on other securities, which all else equal would require a lower fed funds rate path to provide the same level of accommodation. That lower funds rate path would provide less scope for direct short term policy rate adjustments. (There always an offset somewhere!) However, with the long-run neutral rate already likely to remain lower, the latter problem would likely persist regardless of which balance sheet option members chose.

Financial Conditions Improved, Most Comfortable with Hold/Patience for “Some Time”

The Fed acknowledged its own impact on markets as “prices for equities and other risk assets reportedly were buoyed by perceptions of an accommodative stance of monetary policy”

With regard to risks to the economic outlook, “Some participants viewed risks to the downside for real GDP growth as having decreased, partly because prospects for a sharp slowdown in

global economic growth, particularly in China and Europe, had diminished. These improvements notwithstanding, most participants observed that downside risks to the outlook for growth remain.” *So, a patient approach would still be warranted for “some time” even given what participants knew at the end of April.*

There was no mention of a possible rate cut, indeed “a few” still pointed to the potential need to firm policy if the economy evolved as expected as “the Committee would need to be attentive to the possibility that inflation pressures could build quickly in an environment of tight resource utilization.”

Others were not convinced on the tight economy assessment, as “a few other participants observed that subdued inflation coupled with real wage gains roughly in line with productivity growth might indicate that resource utilization was not as high as the recent low readings of the unemployment rate by themselves would suggest.”

Beyond that, “Several participants commented that if inflation did not show signs of moving up over coming quarters, there was a risk that inflation expectations could become anchored at levels below those consistent with the Committee’s symmetric 2 percent objective—a development that could make it more difficult to achieve the 2 percent inflation objective on a sustainable basis over the longer run.”

Bottom Line: Watching Incoming Data and Risks

Taken together, there is little appetite for a near-term hike, nor is there much appetite for a preemptive cut in the Minutes, nor in recent Fed speak.

It’s worth noting that even dove Bullard noted Monday that China-U.S. tariffs might have to stay in place for six months before weighing on Fed policy—a benign view that is not the market’s current conclusion.

On Monday, Fed Chair Powell noted that the outcome of trade talks are unknown, and that it would be “premature” to judge or act. The central bank took a similar tack with tax cuts, adjusting forecasts and acting only after legislation was passed and the early economic impacts became clearer.

There will be changes ahead, but over the near term it’s a holding pattern as the U.S. economy and labor market perform well, with investors and the Fed attentive to risks in an environment of moderate inflation pressures.

Addendum: Fed Conference in Early June Will Flesh Out Longer-Term Issues

Early June brings a Fed conference on monetary policy strategy, tools, and communications. Attendees will discuss the pros and cons of possible changes to each dimension, very likely including:

- a higher inflation target,
- price-level or nominal GDP targeting,
- direct yield curve targeting in a crisis,
- a better sense of future QE/forward guidance tools,
- switching to an inflation range, not a point 2% target,

In a Q&A Monday, Powell gave a nod to potentially switching to a range for the Fed's inflation target, a popular alternative to a 2% point target. That would allow in our view a bit more flexibility, and could diminish the current expectation that the Fed tends to treat 2% as a ceiling in practice, even as it stresses a "symmetric" target.

Yield curve targeting is also increasingly popular, already part of the Bank of Japan's strategy.