Is the Fed at Neutral?

All eyes will be on the US House of Representatives Financial Services Committee tomorrow, which sees Fed Chair Powell deliver the first of two days of semiannual testimony. Of course, the monetary policy outlook will be awaited with baited breath by the markets.

With US economic data mixed at best (generally weak PMIs but a much stronger than expected jobs market release), and the trade war still not fully erupted, will the current scenario see the Chair confirm the market's expectation of a rate cut at the end of the month?

The idea of a 50 bps cut has receded from market-implied probabilities for the July 31 meeting, but 25 bps remains the central expectation.

The risk (which has been creeping into the market since the strong jobs print last week) is that anything short of a full-throated endorsement of a reduction in the Federal Funds Rate will be seen as a hawkish surprise, with the expected market reaction (USD and yields higher, equities and risk assets lower) to follow. This is not to mention whatever the President might have to say about such "disappointing" testimony.

But is policy really too tight? Most of the curve flattening we have seen in the past several months has come from the long end falling rather than the short end rising, although inflation expectations have been bouncing around at three-year lows.

The latest Summary of Economic Projections ("the dots") for the longer run policy rate have fallen to 2.5% with the June update. The Laubach-Williams estimate of r* (the neutral policy rate) comes in just over 2.4%. And, of course, the current Fed Funds rate is - you guessed it - also 2.5%.
Thus, there is a good argument to make that rates are currently "appropriate". That is, they are appropriate as long as you believe the real economy and inflation are also around their trend levels.

If, however, you believe that the economy is now running below potential (or is about to veer that way) or you think an insurance policy is necessary, then a rate cut would be warranted. This encapsulates the difficulty policymakers have when trying to formulate policy under so much uncertainty about the outlook.

Add in trade policy uncertainty, and the current political pressure to which the Fed is being subjected and the case for rate cuts sits balanced on a knife edge. Expect Powell to describe that knife edge without offering a sure thing one way or the other.

If we're right, such a hawkish surprise (short of signaling a cut on July 31) would continue to keep the USD bid and equities on the back foot.

**Is the Federal Funds Rate now at Neutral?**

![Current FFR and estimates of $r^*$](image-url)

*SOURCE: Bloomberg, data for 9 July 2019*

Please direct questions or comments to:

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