Fed to Fire First in Fight for Global Reflation

- We expect a 25 basis point cut in the Federal Funds rate
- Depending on how the forward guidance is presented with the decisions, markets might be disappointed
- Global reflation is the name of the game; the Fed might not be enough to bring USD lower. Click here for a deeper dive

We expect the Fed to cut rates by 25 basis points on July 31; while market pricing reflects a nontrivial expectation of a larger cut, we don't feel that conditions justify a policy move that in the past only occurred in the midst of a financial crisis.

The post-meeting press conference will be just as important to the market reaction as the decision itself. Will Chair Powell couch the move as merely an insurance policy against "global risks" or will he position it as the beginning of a new easing cycle?

We expect that Chair Powell will leave the Fed with sufficient optionality going forward, presented with some version of "the FOMC will monitor conditions and stands ready to act to sustain the expansion."

In fact, we view the move as one of many shots still to be fired in a global war pitting central banks against the forces of disinflation that have been unleashed by global concerns over policy risks - namely trade tensions and Brexit. Expect some mention of declining inflation expectations and the Fed's wish to get these expectations back up.

The yield curve flattening/inversion we have seen in the US and all over the world is
occurring from the long end. Falling growth expectations (reflected in lower real interest rates) and falling inflation expectations portray an economy - in the US and abroad - in the midst of falling aggregate demand, the result of a long, unresolved period of uncertainty over the future course of global economic institutional arrangements.

As a result, central banks are yet again left trying to confront declining sentiment with the blunt tools of monetary policy. Given that (as we mentioned above) the decline in inflation and growth expectations is the result of policy uncertainty, we're not sure that monetary policy - whether cutting rates further or expanding balance sheets - can address what is really ailing the global economy.

While the slope of the global yield curve is currently at its flattest level of the 21st century, it's not just in the bond market that we see this decline in aggregate demand; export growth around the world has been falling and in many countries is contracting.

Nevertheless, the monetary authorities - beginning with the Fed - will do their best to confront falling inflation expectations stemming from these policy worries. We are on the cusp of another effort around the world to reflate the global economy.

This is one reason why dollar bears might need to find another reason to sell the buck. With policy rates expected to fall around the world, relative expected policy differentials don't seem to us to be uniformly lining up against the USD.

We note that the "dump the dollar" chant grew loudest right after Chair Powell's congressional testimony to Congress on July 17; since then - including 24 hours of confusion after NY Fed President Williams speech left some to infer 50 basis points of cuts were on the way - DXY is two big figures higher, close to the top of its two-year range.

Click here for a deeper dive.

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