LPL RESEARCH

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THE FED'S COURSE CORRECTION

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KEY TAKEAWAYS

The Fed cut interest rates for the first time in 10 years.

Economic data still doesn't warrant a cut, but U.S. businesses need a confidence boost.

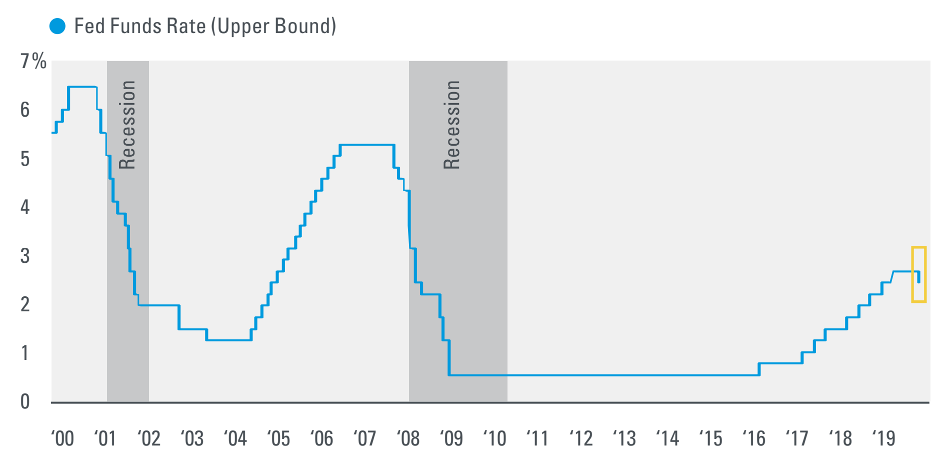
This rate cut will likely not be a one-and-done event.

The Federal Reserve (Fed) completed its U-turn in policy last week. Policymakers announced a 25-basis point (0.25%) rate cut July 31, its first in 10 years [Figure 1].

Rate cuts have been a sobering reality in investors' short-term memories, as the Fed resorted to a series of rate cuts to get the U.S. economy out of the depths of the financial crisis in 2008–09. The economy is much different now—in strength and in structure—so it has been difficult for investors to understand the Fed's intentions in this decision.

Fed Chair Jerome Powell's post-meeting comments made it clear to us that this rate cut was a "course correction" in policy, a common strategy in economic expansions (except for the previous one). We believe the cut was justified despite a largely steady economy and that the economic impact will be in line with the Fed's intentions.

1 THE FEDERAL RESERVE'S FIRST RATE CUT IN 10 YEARS



Source: LPL Research, Federal Reserve 07/31/19

BOOST SENTIMENT

The Fed typically cuts rates to stimulate economic growth. Since 1990, the Fed has cut rates 26 times during expansions. On average, gross domestic product (GDP) increased 0.5% in the quarter after a rate reduction. Theoretically, lower interest rates should lead to higher spending as consumers and businesses take advantage of lower borrowing costs.

Economic data alone doesn't justify a rate cut. The labor market has stood strong against trade tensions, and the state of the U.S. consumer is healthy. Even inflation is showing signs of life: Core personal consumption expenditure (PCE) prices have risen an average of 0.2% over the past three months (as of June 30), the fastest growth in nearly seven years. Core PCE's recent momentum is promising, even though year-over-year growth is still below the Fed's 2% target.

In this situation, the Fed's impact on corporate sentiment could be valuable. Fed Chair Jerome Powell noted that the Fed's flexible posture could be more important than the rate cut itself, and U.S. companies are in need of a confidence boost amid global uncertainty. Consumer activity is strong, and consumer confidence has climbed back near cycle highs, yet U.S. business spending remains muted. We understand corporations' struggle: It's tough to plan capital expenditures when global uncertainty is rising and revenues are more linked to international economic performance than ever before. An accommodative Fed could offer enough encouragement about U.S. economic prospects for businesses to invest in growth.

Financial market sentiment could also benefit from an easing Fed. The U.S. yield curve has been inverted (long-term yields below short-term yields) for almost three months as bond investors have signaled their discontent with monetary policy. Loosening monetary policy and ending balance sheet sales may help steepen the curve into a more normal shape.

AID THE GLOBAL ECONOMY

The Fed's unofficial third mandate is global stability, and that directive is crucial these days. While the domestic economy is sound, the global economy has slowed, and the Fed must be aware of global risks. Looser Fed policy should help ease pressure on other currencies by curbing the U.S. dollar's recent rally, thus boosting global demand and stemming capital outflows from other countries. This is a tougher dynamic to manage, though, as other central banks have enacted more drastic monetary policy measures.

WHAT'S NEXT?

Powell made it clear that the Fed's intention isn't to cut rates significantly at this juncture, mentioning that last week's reduction wasn't the start of a "lengthy cutting cycle."

However, a Fed rate cut is rarely a one-and-done event, as it typically leads to a more long-term shift in policy strategy. Since 1990, the Fed has cut rates an average of five times in 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.

Still, fed fund futures are pricing in three more 25-basis point (0.25%) rate cuts by the end of the year. We think that's excessive, and Powell's commentary demonstrated the Fed's strategy of using communication to steer investors away from lofty policy expectations. Of course, the Fed will step in and do whatever is needed, but we're likely far from a dramatic policy shift.

CONCLUSION

The Fed has started to course correct as part of a risk-management strategy, not as a response to imminent recession. Still, we think the Fed will cut its policy rate by another 25 basis points (0.25%) before 2019 is over to reassure investors, buoy the yield curve, and ease pressure on global currencies.

The United States' most recent tariffs threat shows the trade dispute is far from over, and global uncertainty could persist without resolution. ■

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