KF SPOTLIGHT: DOES THE FED REALLY NEED TO CUT RATES?

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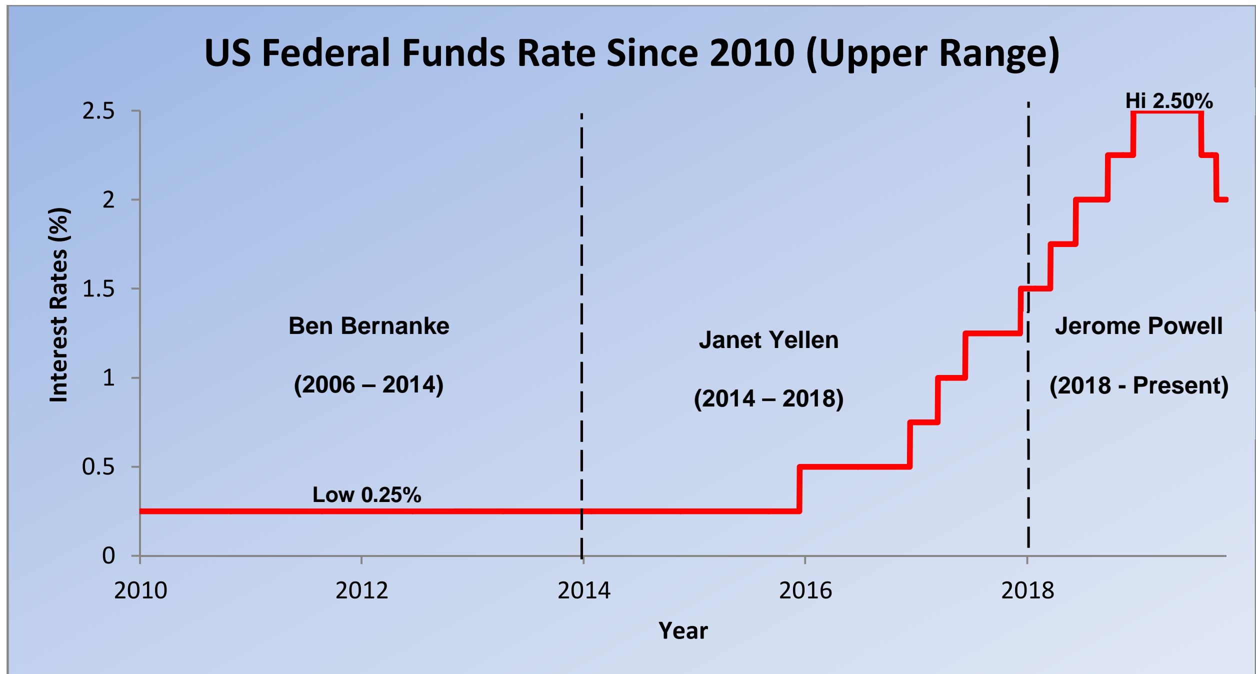
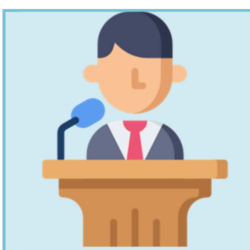


Source: Bloomberg

Review

Period	Decision
Ben Bernanke (2006-2014)	➢ Post 2008 financial crisis, the Fed kept the rate at nearly zero.
Janet Yellen (2014-2018)	➢ In late 2015, the Fed began to raise the interest rates as the US GDP growth has begun to stabilize to record 2.9% year-on-year growth ➢ In 2017, the rate was hiked thrice on its path of normalizing its benchmark rate
Jerome Powell (2018-Present)	➢ In 2018, the Fed decided to increase the rates four times in view of steady US GDP year-on-year growth at 2.9% ➢ However, the Fed had cut its benchmark rates for the first time since 2008 recession on July and September 2019 to weather the uncertainty surrounding global developments.



- 2019 witnessed the Fed lowering the interest rates twice where the Fed chairman, Jerome Powell, cited “muted inflationary pressure” and “the implications of global developments” as the factors of the decision.
- However, the question remains: does the Fed really need to cut the rates?

On September 18, 2019, the Federal Open Market Committee (FOMC) decided to lower the target federal funds rate range to between 1.75 percent and 2 percent, citing the need to pursue the 2 percent inflation target, one of the two official mandates of the Federal Reserve. It was a decision made by a somewhat divided FOMC, with seven of the ten members voting for a rate cut, two calling for the status quo to be maintained, and one who called for even lower target rates.

In the press conference that followed the policy meeting, while Fed Chair Jerome Powell insisted that a U.S. economic recession is not on the horizon, he nonetheless emphasized that the rate cut is needed to support economic expansion. The FOMC, in a statement following the September meeting, maintained that the U.S. labor market remains strong and household consumption is on the rise. Business investment and export figures also weakened. Most importantly, inflation remains well below the Federal Reserve's self-imposed 2 percent benchmark.

ECONOMIC INDICATORS

1. *Inflation is below target*

The Federal Reserve's unwillingness to tighten monetary conditions, on the basis of an unmet target of 2 percent, is not unfounded. When an economy is consistently registering low inflation rates, it runs the risk of slipping into the deflation, as evident in the decades-long stagnant Japanese economy (see Diagram 1.1). What is different from the Japan story, however, is a sound recovery in economic growth and employment in the U.S. economy since the Great Recession. In fact, when interest rates were raised between the end of 2015 and prior to President Donald Trump's trade war with China, the U.S. economy saw moderate but consistent GDP growth (see Diagram 1.2).

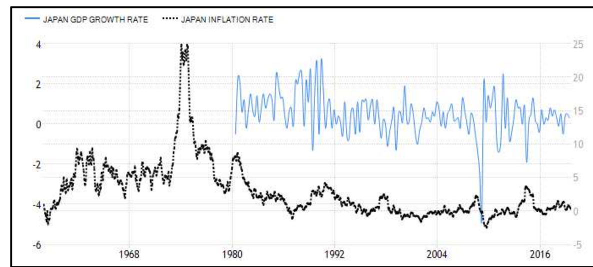


Diagram 1.1 Japan GDP Growth vs Inflation Rate

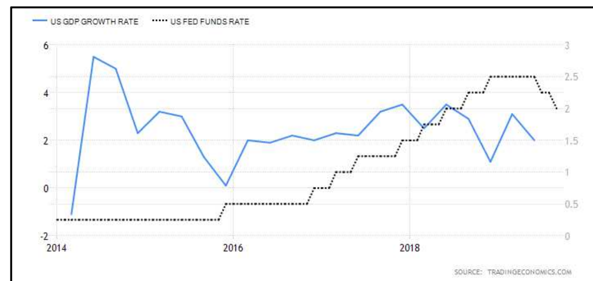


Diagram 1.2 US GDP Growth vs. Fed Funds Rate

2. *US consumers are driving economy*

When Janet Yellen's Federal Reserve ended the era of zero interest rates in December 2015, the U.S. Personal Consumption Expenditure Index (PCE) has since risen in tandem with the Fed Funds Rate, as seen in Diagram 2.1, even after the U.S.-China trade commenced. The strength of American consumer sentiment had been driven by an appreciation of the dollar, as illustrated in Diagram 2.2. Interestingly, the distortion of the consumer sentiment-dollar relationship occurred most evidently when U.S. tariffs on Chinese goods went into effect.

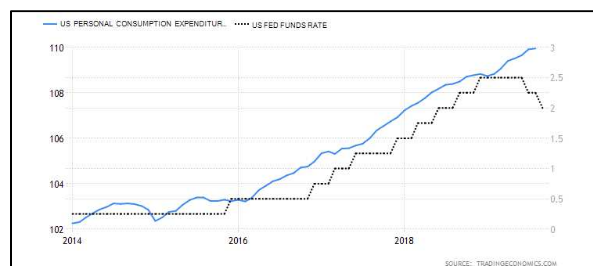


Diagram 2.1 PCE vs. Fed Funds Rate

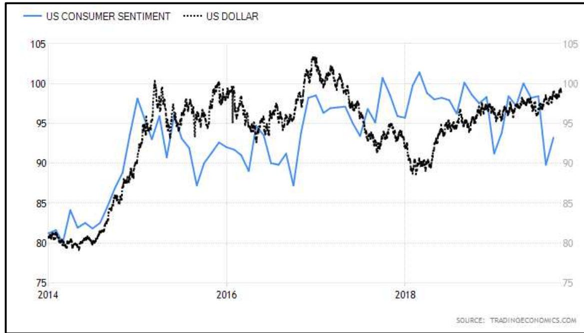


Diagram 2.2 Consumer Sentiments vs. USD

3. *Unemployment is at 50 year low*

The unemployment rate went as high as 10.2 percent during the Great Recession but has fallen steadily over the decade as the economy recovered. Just recently, the September unemployment rate fell to 3.5 percent, a level last seen in 1969. That meets at least one of the two Federal Reserve mandates. Even when the Fed Funds Rate was gradually hiked, employment numbers improved (see Diagram 3.1). In other words, monetary easing is not always necessary to stimulate hiring. The productivity of American workers also has improved in recent years (see Diagram 3.2), despite a rather stagnant wage growth in the past five years.

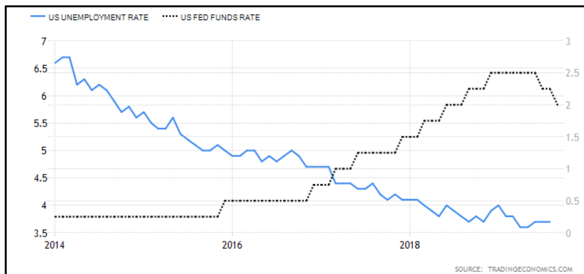


Diagram 3.1 Unemployment Rate vs. Fed Funds Rate

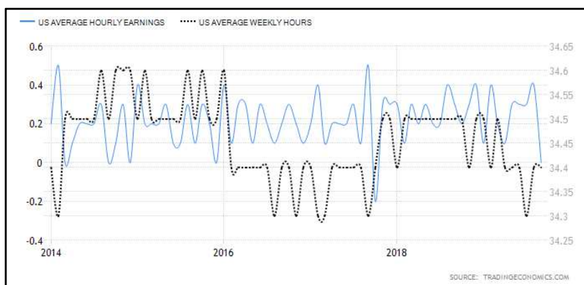


Diagram 3.2 Hourly Earnings vs. Hours Worked per Week

4. *Economy Continues to Grow*

The U.S. economy is in its 11th year or 121 consecutive months of expansion, the longest run in the country's history. At the peak of the Great Recession, the world's largest economy experienced Gross Domestic Product (GDP) contraction of -2.8 percent. The 2.6 percent growth in the first half of 2019 dismisses the notion that the U.S. economy is struggling for growth. As a matter of fact, the world's largest economy registered negative GDP growth in only 3 quarters between 2011 and 2019 (see diagram 4.1).

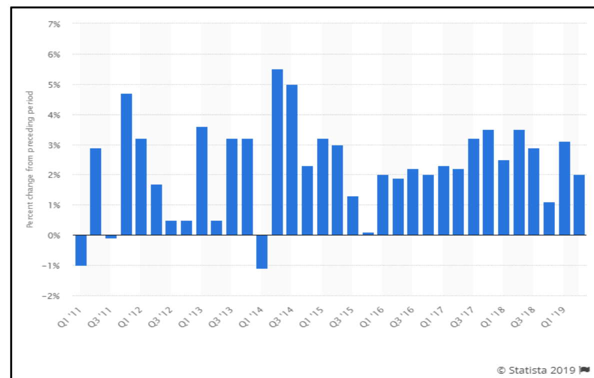


Diagram 4.1 US Quarterly GDP Growth (2011-2019)

5. *Housing market is strong*

With real estate comprising 15 percent U.S. GDP, the recovery in the housing market is an indication that the economy is on a strong footing, as seen in rise of new and existing home sales since the subprime (refer to Diagrams 5.1 and 5.2). In the first quarter of 2019, the average equity per borrower of home loans in the U.S .stood at $171,000, up more than double from the same period of 2010.

Diagram 5.1 New Home Sales

Diagram 5.2 Existing Home Sales

6. *Lower Business Confidence*

The failure of U.S. and China to reach a trade deal has business confidence in the U.S., specifically the ISM Manufacturing PMI, which has seen a sharp decline since 2018 when the trade war began (see Diagram 6.1). Companies are less likely to invest in times of uncertainty, reducing their contribution to GDP growth. The reluctance of employers to hire when business confidence is low will eventually hurt the labor market, to which the Federal Reserve is obligated to react.

Diagram 6.1 ISM Manufacturing Purchasing Manager Index

7. *Negative Rates are not proven to be effective*

In the press conference after the September FOMC meeting, Chairman Powell dismissed the possibility of bringing interest rates into the negative territory, even in times of crisis. For a consumer-driven economy like that of the U.S., negative rates monetary policy is futile, to say the least. Negative interest rates introduced by the Bank of Japan (BoJ) in 2016 failed to stimulate consumption by the Japanese (see Diagram 7.1), who have historically had higher saving rates than the Americans. Therefore, there is little reason to believe interest rates below zero will help boost the U.S. economy.

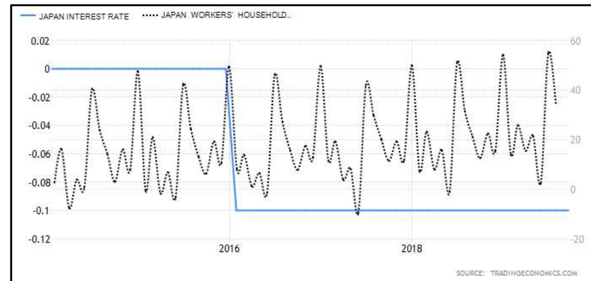


Diagram 7.1 Japan Interest Rate vs. Consumption

The Fed doesn't really have a choice, does it?

Monetary policymakers, including those of Japan, Sweden, Denmark, and Switzerland and the Euro Area, have taken borrowing costs to the negative territory. Australia, whose economy has not experienced a recession in a quarter of a century but too is struggling with low inflation, saw its official cash rate slashed to a record low of 0.75 percent. Fearing that a prolonged U.S.-China trade war will exacerbate an already slowing global economy, these dovish central banks are somewhat forcing the FOMC's hand into lowering the Feds Fund Rate target to near zero.

After all, there are only 187 basis points more to cut until lenders need to pay interest to hold debt. Given the strength U.S. consumers and real estate market, the economy is rather immune to further monetary stimulus. The Fed might have to accept that little can be done to meet their inflation target. Yet financial markets are defying conventional wisdom by cheering monetary easing, which is by textbook definition an expectation of and a remedy to an ailing economy, instead of an actually healthy economy.

Investors were quick to express their fears and fled to safer assets, driving down longer-term yields against shorter-term ones. Since 1950, inversions between the 3-month and 10-year Treasury yield curve have preceded economic recessions on seven occasions. If history is any indication, markets saw the recent inversions as warning of an impending downturn in the next two years. What history and markets overlooked, however, is the record low interest rate environment we have had in recent years. This late in the economic cycle, after a decade of expansion and bull market, it is natural that

investors to see longer-term yields come down, especially when central banks outside the U.S. continue to loosen monetary policies. Even if a recession is inevitable in the next 24 months, it does not mean the U.S. economy has no room to grow, with or without a rate cut.

If the Federal Reserve is truly “data dependent” and politically independent, it needs not hurriedly slash interest rates, even under President Trump’s constant pressure to do so. Neither can the Fed sit back and wait for the trade war wreak total havoc in the U.S. and global economy before taking any action. At this point, Chairman Powell’s only option appears to be playing the role a passive-aggressive central banker: conceding small cuts to preempt an economic catastrophe but at the same telling markets that there is little to worry about. It is akin to a doctor prescribing medication to a distraught patient with a benign tumor for fear that a malignant cancer may develop.

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