Economics & Strategy

DBS Flash

Fed poised to cut, but only with much more soft data

Economics/Strategy/Rates/FX

Group Research

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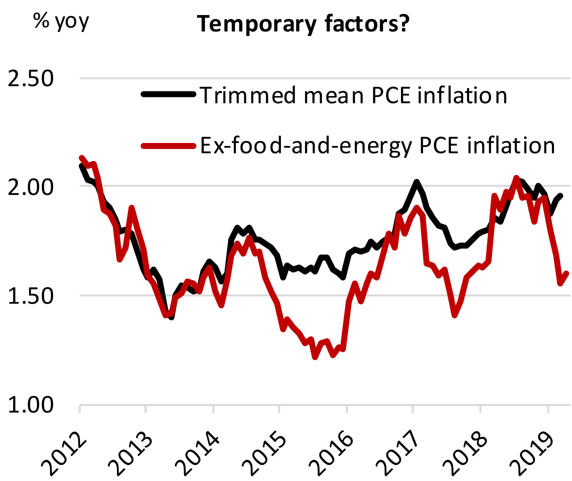
- *The US Federal Open Market Committee has done enough to please the markets with a few dovish phrases*
- *FOMC members are moving in the direction of rate cuts, but the data are far from justifying such a move*
- *Growth may not be very strong, but by no means weak at this juncture in the cycle*
- *Inflation may be soft, but only marginally so, and there are upside risks from oil and trade wars*
- *Financial conditions are comfortable*
- *Cutting too readily will undermine the central bank's independence.*
- *We don't think the data would change enough to warrant a July rate cut*
- *Cuts in September and December more likely, in our view*
- *The market is taking weak inflation and growth as a done deal; we have some reservations*

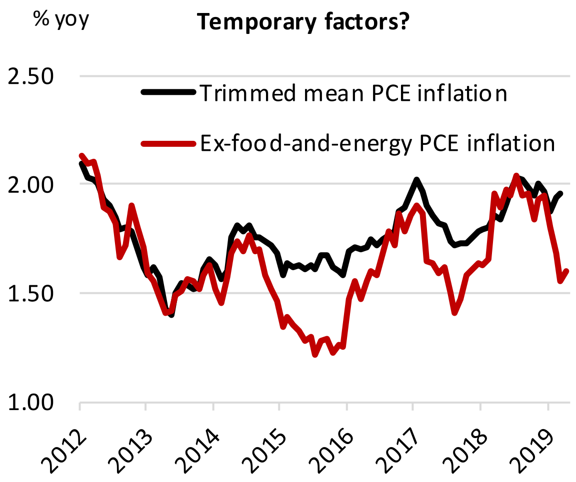


Source: Federal Reserve Bank of Dallas, DBS

The Fed does enough to satisfy the markets for now

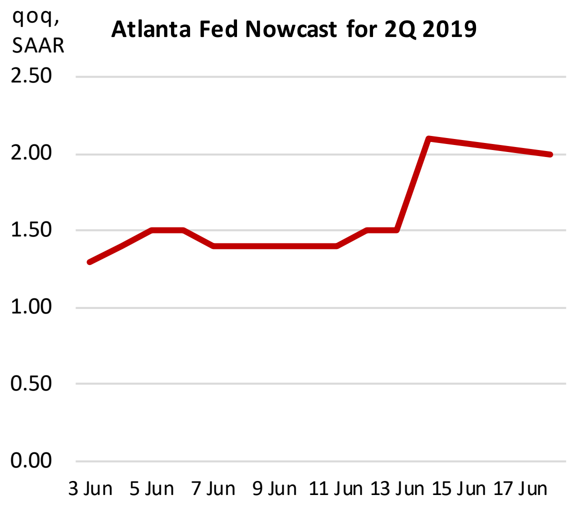
Stating that it would "act as appropriate to sustain the expansion," the US Federal Reserve concluded its June meetings overnight, leaving the Fed Funds rate unchanged, but hinting strongly that cuts are on the way. These hints were clear from the removal of the word "patient" from its forward guidance, substitution of "solid rate" by "moderate rate" as the description of the pace of economic expansion, and the observation that inflation remains below 2%.

The dovish shift may be sufficient to please the markets, but it should be clear that the shift in stance was not seismic. The US central bank officials have demonstrated eagerness to ease financial market conditions from the beginning of this year. But at the same time, they have tried to assert their independence in the face of growing intervention from the White House. This was seen even last month when Chairman Powell argued that some of the slowing of inflation in recent months was likely due to transitory factors. Indeed, analysis done by the Dallas Fed show that core inflation has been on an uptrend since 2013, interspersed with temporary downshifts. In fact, a comparison of trimmed mean and core PCE (which excludes food and energy) shows that core PCE tends to deviate far more than the underlying rate of inflation. We are sure that Fed officials will keep this in mind as they consider forthcoming data. This means that although the next cut is likely to be defended as an insurance against below-target inflation, that evidence is nowhere close to being compelling.



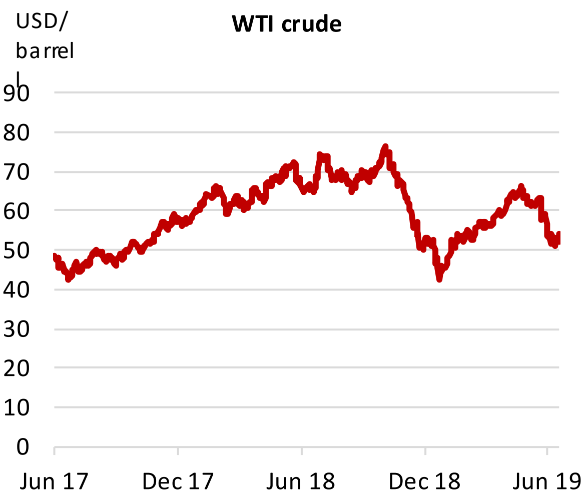
Source: Federal Reserve Bank of Dallas, DBS

Beyond inflation, the dataflow with respect to economic activity is hardly weak. Since the beginning of this month, releases such as retail trade, industrial production, and housing starts have been robust, pushing up Atlanta Fed's 2Q GDP Nowcast to above 2%. To be sure, trade wars have undermined business sentiment, and there are genuine headwinds to the electronics cycle, but US energy and housing sector activities, along with labour market statistics suggest a fairly healthy growth environment.



Source: Federal Reserve Bank of Atlanta, DBS

In the event of a breakdown in trade negotiations between the US and China, there could be immediate jump on a range of consumer product prices in the US. Further tension in Iran could push up crude oil prices. Tight labour market could leave wages growing strongly even if margins are under pressure. These developments could push up inflation expectations and complicate the Fed's job considerably in the coming months, in our view. An easing narrative is conventional wisdom, but may not work out the way the markets want



Source: Federal Reserve Bank of St Louis, DBS

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Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).