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A HIGH BAR FOR LOWER RATES

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KEY TAKEAWAYS

Markets are positioning for the first Fed rate cut in 10 years.

Consumer inflation has weakened, but we (and the Fed) believe the slowdown is temporary.

Improving economic conditions support a continued Fed pause.

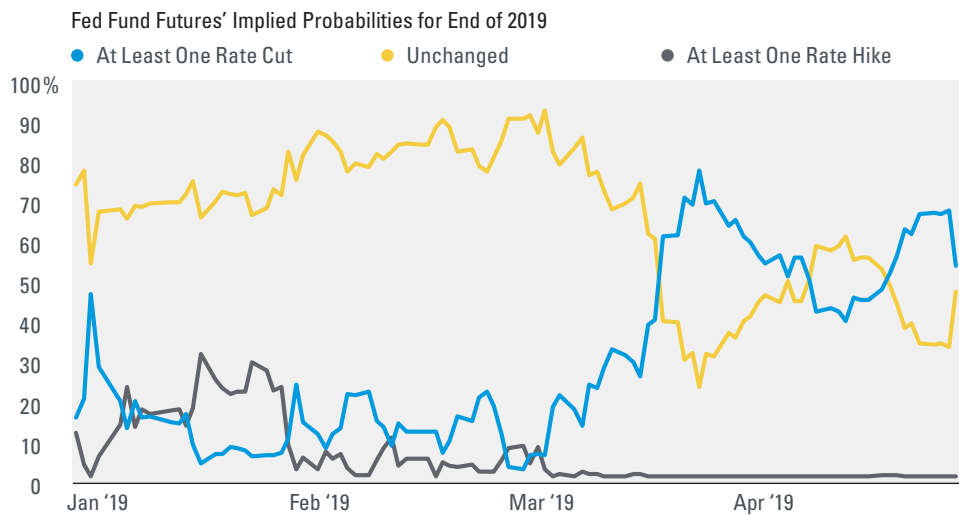
Once again, the Federal Reserve (Fed) and the markets are at odds with each other. The Fed announced it would keep rates unchanged at the conclusion of its most recent policy meeting on May 1, and Fed Chair Jerome Powell delivered comments that mirrored what he's said for the past few months.

Still, bond markets are staunchly positioned for a lower fed funds rate, even as economic data have shown signs of recovery. Fed fund futures are pricing in more than a 50% chance of a rate cut in 2019, and short-term yields have dropped below the upper-bound fed funds rate for the first time this cycle. While investors are literally buying into this possibility, we see the Fed's continued pause as the most prudent approach [\[Figure 1\]](#).

SLOWING INFLATION

Investors' main worry seems to be inflation, based on the markets' reaction to Powell's post-meeting press conference. Powell repeated several times that further patience is appropriate because inflation has slowed due to transitory factors, such as apparel prices, airfares, and market-sensitive fees in investment management. But that patience, which soothed stocks earlier this year, spurred a 1% intraday sell-off in the S&P 500 Index.

1 FED FUND FUTURES BRACING FOR RATE CUTS



Source: LPL Research, Bloomberg 05/03/19

The economic forecasts may not develop as predicted.

Nervousness around the state of inflation is understandable. Consumer inflation has weakened since the Fed last hiked rates in December. Core personal consumption expenditures (PCE), the Fed's preferred inflation gauge, rose 1.6% year over year in March, its slowest pace of growth in 18 months. While that pace isn't alarmingly slow, the downward trend runs counter to the Fed's intentions.

Markets think the grace period for a "transitory" excuse has passed, but Powell has a point. Most inflation data are current through the end of the first quarter, which was fraught with global economic volatility. Policymakers haven't seen enough data to get a clear reading on the state of U.S. inflation without the impact from global turmoil, which has eased in recent weeks. Powell also correctly noted that core PCE growth stayed close to 2% for much of 2018, so fundamentals before the first quarter volatility supported the Fed's inflation target.

Other measures of inflation also point to higher pricing pressures ahead. Powell cited the Fed

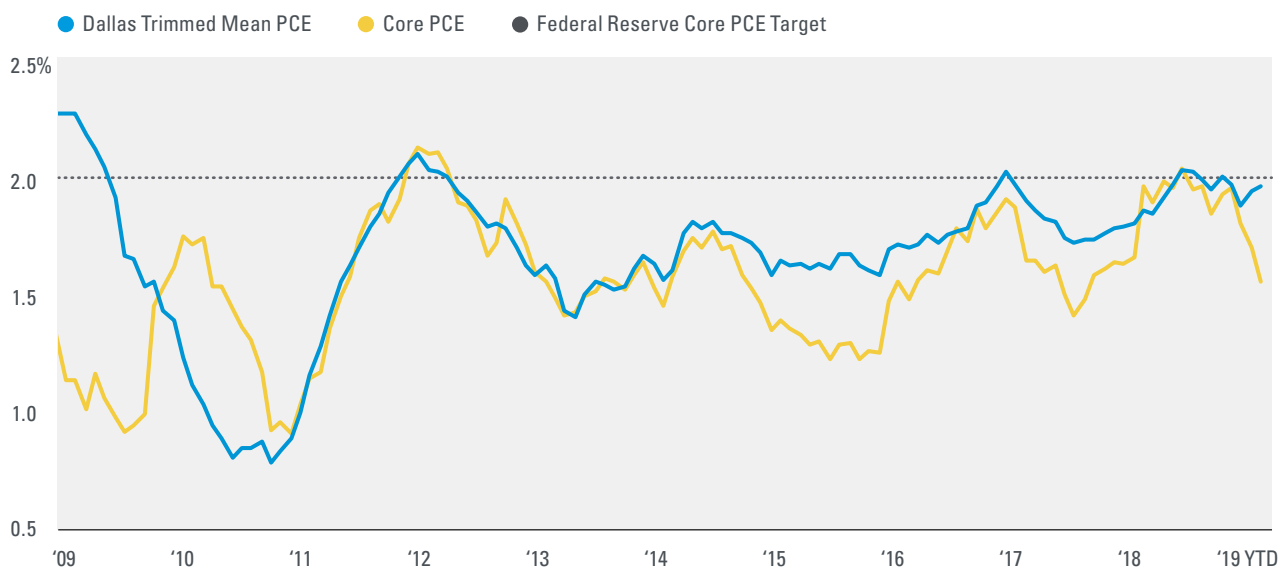
Bank of Dallas' "trimmed mean" PCE measure as evidence of this. The trimmed mean PCE, which has proven to be a less volatile version of core PCE, has hit 2% year-over-year growth for the past several months [Figure 2]. Wages, which account for about 70% of business costs, and producer prices have grown at cycle-high paces during this period.

TRACK RECORD

It's tough to make a case for lower rates with over 3% gross domestic product growth, healthy wage growth, and a labor market close to full employment. Based on recent history, there has been a high bar for a rate cut (and rightfully so).

The Fed has cut rates 42 times since 1990, with the last rate cut happening in December 2008. Only nine rate cuts occurred after a quarter with output growth of 3% or more. In all of those instances, either leading indicators signaled impending weakness because of market crises, or unemployment was stubbornly high. Neither of

2 SLOWING CORE PCE DUE TO TRANSITORY FACTORS



Source: LPL Research, Bureau of Economic Analysis, Federal Reserve Bank of Dallas 05/03/19

PCE= Personal Consumption Expenditures

Core PCE excludes food and energy prices.

Dallas Trimmed Mean PCE is calculated by omitting a certain fraction of the most extreme changes in PCE components each month.

these conditions fit today's environment. Leading data point to a rebound from a somewhat-soft first quarter, and the April jobs report showed robust job creation and cycle-low unemployment.

If consumer inflation picks up, the U.S. economy will be near full employment with healthy inflation across the board, fulfilling the Fed's dual mandate. Global stability is also of concern, but the lack of clarity and stable domestic growth both support a wait-and-see approach.

We'd also expect more warning if the Fed does change course in policy. Between December and January, Fed officials changed their tone in public communication and worked more flexibility into their messaging. Looking back, we now know they were prepping investors for the pause in rate hikes announced three months ago. If the Fed anticipates moving rates in either direction, policymakers will likely work signals into their communications to avoid a market shock from a surprise announcement.

IOER "CUT"

Policymakers did cut one rate at this last meeting, but don't read too much into it. The Fed reduced its interest rate on excess reserves (IOER) 5 basis points (0.05%) to 2.35%. Powell was careful to

emphasize that the change in IOER was a technical adjustment—not a policy decision—made to keep the effective fed funds rate within the set bounds. While the IOER is an active rate paid to banks for excess capital, the upper-bound fed funds rate is the more appropriate rate to reference for policy. For now, that upper-bound rate has stayed constant.

CONCLUSION

Investors have become fixated on the idea of a rate cut, but we think lowering rates would be premature in this environment. There is still substantial global uncertainty, even as economic data have improved. The global economy is still early in recovery mode, and we have yet to see a definitive resolution in U.S.-China trade talks. The Fed has faith in the U.S. economy, and policymakers understand the consequences of unnecessarily loosening policy.

Right now, we see more evidence that inflationary pressures will pick up as global growth stabilizes over the next few months. If that happens, we think the Fed will lean toward raising—not reducing—rates. ■

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