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Marketing Material

CUTTING RATES FOR THE RIGHT REASON?

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IN A NUTSHELL

- The U.S. Federal Reserve (Fed) remains dovish. Lately, it has also been stressing structural reasons for low inflation.
- In recent data, we continue to see drag from trade-related uncertainties, justifying a pre-emptive 25bps cut.
- Political conflicts as well as easing by other central banks may have accelerated the shift in Fed policy and communication.

By the standards of central bankers, Jerome Powell was unusually clear in his July testimony to the U.S. House of Representatives: "The relationship between unemployment and inflation became weak. […] It's become weaker and weaker and weaker."[1] The Chairman of the U.S. Federal Reserve (Fed) also stressed that the Fed has been "learning" that the neutral interest rate[2] as well as the neutral rate of unemployment[3] appeared to be lower than previously estimated. Therefore current monetary policy was not "… as accommodative as we [the FOMC] had thought."

What a remarkable shift in communication and not just compared to, let alone, the often opaque testimonies of the Greenspan years. Powell's illustrious predecessor Alan Greenspan reportedly and famously used to quip along the lines of: "I know you think you understand what you thought I said but I'm not sure you realize that what you heard is not what I meant." By contrast, Powell's testimony was nearly the same as an outright announcement that soon there will be a (major) change in the monetary-policy guidance.

Just over a month ago, at the time of the June meeting of the Federal Open Market Committee (FOMC), the Fed mostly justified turning dovish by blaming trade-war related uncertainties, weaker global growth and based on this, a deterioration of business sentiment and investment. To be fair, the Fed has also been mentioning inflation weakness, despite strong labor markets, at nearly every meeting. In particular, the Fed appeared to explain inflation weakness earlier in the year by stating that alternative measures[4] of inflation, such as the ones that exclude volatile food and energy prices, would run around the two percent target. According to the June meeting minutes[5], several participants still expected inflation to return towards that two percent target, albeit at a slow pace. Only a few participants[6] showed concerns that structural factors (e.g. remaining slack in the labor markets) could offer an explanation as to why inflation had been muted.

In light of Powell's Congressional testimony, it appears that the Fed is now searching for more substan-

[1]Source: https://www.bloomberg.com/news/articles/2019-07-11/powell-says-fed-has-room-to-cut-may-have-kept-policy-too-tight as of 7/11/19
[2]In economics the natural rate of interest is defined as the interest rate that will keep inflation constant at the central bank's target while fostering maximum employment at stable growth.
[3]The natural rate of unemployment (or NAIRU – non-inflationary rate of unemployment) is the rate of unemployment that keeps inflation constant. If the actual unemployment rate is below the neutral level, inflation is expected to rise.
[4]Source: Fed Dallas (https://www.dallasfed.org/research/pce) as of 7/16/19; trimmed-mean inflation: an alternative inflation measures that (dynamically) excludes the most volatile prices from its calculation. The latest value is at 2.0% year-on-year.
[5]Source: https://www.federalreserve.gov/monetarypolicy/fomcminutes20190619.htm as of 7/16/19
[6]There is a hierarchy in the meeting minutes to indicate how many FOMC participants are supporting a position: all, most, many, several, few – the first two have become fairly rare recently, which is an indication that discussions may have been quite diverse and lively in the recent past.

tial justifications to ease monetary policy. It has turned away somewhat from the pre-emptive easing philosophy (insurance cut/s to shield the economy from external factors) and towards a framework in which current labor markets do not produce sufficient inflation pressure. Understanding this shift may help to make sense of the future course of monetary policy.

For the July FOMC meeting, market participants are mostly split between those expecting a 25 basis points (bps) or a 50bps interest-rate cut. This is partly caused by mixed economic data released between the June meeting and Powell's recent remarks. To recap quickly, June's labor-market report was strong: 224,000 new jobs have been added to the U.S. economy – a major bounce back from the slump in May (only 72,000 new jobs). In line with how U.S. employment generally breaks down, the biggest gains were in the service sector. While in 2018 the average quarterly job creation was around 670,000, the two first quarters in 2019 average around 510,000. That deceleration is well in line with our expectations for an aging business cycle, and a shrinking pool of unemployed. Average hourly earnings increased only by 3.1% year-on-year in June, the same as in May. The uptick in the unemployment rate to 3.7% was not a sign of weakness. Inflation, however, continues to paint a mixed picture. Headline inflation for the consumer price index (CPI) eased to 1.6% year-on-year. The core measure[7] was at a firm 2.1% year-on-year. The main dampener on inflation remains energy related (-3.4% year-on-year) while service inflation[8] – in our view a sounder gauge for domestically generated prices pressure – remains strong at 2.8% year-on-year. Overall, industry sentiment[9] deteriorated further in June. At least, hard economic data shows signs of stabilization: industrial production was flat in June compared to May and manufacturing production even accelerated slightly on a monthly basis. On the demand side we observed pockets of strong data. Retail sales have been robust, beating consensus estimates significantly, while consumer sentiment[10] for June dropped to 121.5 from 131.3 (still on high levels).

Our overall take is that the deterioration in sentiment probably reflects continuing trade-war related uncertainties following the widely anticipated G20 meeting in Japan. Trade may have had an even bigger impact on the supply side than on the demand side. After all, current U.S. tariff measures on imports from China mainly target intermediary goods. Their full impact is perhaps yet to come. Despite higher input prices, the reorganization of supply-chains to circumvent tariffs comes at costs and therefore weighs on corporate margins and on sentiment. Given the high degree of trade-war related uncertainty, it appears just as a logical consequence that U.S. corporations would scale back investments and get a bit more cautious on new hires. The U.S. economy approaching full employment might be another reason for the slowing, but still sufficient[11], job creation compared to 2018. What we know for sure is that there are plenty of open jobs available. A good indicator to track this is the open jobs to unemployed ratio.[12] It has bounced back since the government shutdown has ended earlier in the year. It is currently at 1.25 – one of the highest levels since records began. Consumers benefit from this environment: job security supports spending. It also seems as if the trade-war related higher input prices and costs from supply-chain disruptions have not yet fully passed on. Moreover, given the current interest-rate environment, financial conditions remain favorable, supporting households' balance sheets. We expect the U.S. consumer to remain resilient for the time being. However, spending growth is expected to be at a somewhat slower pace than we have observed last year. From this point of view, we are willing to follow the Fed's line of argument that a pre-emptive rate cut appears necessary to support the economy.

Finally, we remain a bit skeptical about the recent structural reasoning of Fed Chairman Powell. We continue to believe that the weak relationship between inflation and low unemployment is less related to higher than anticipated slack in the labor market (i.e. a lower natural unemployment rate), but more a consequence of globalization itself: prices for most goods are generated globally, while service prices are largely generated domestically. This could also explain the slower pace of aggregated wage growth. Wages, in theory, should reflect the marginal productivity of all employees topped up by a margin that reflects competitiveness of the respective company.

[7]Excluding food and energy prices
[8]CPI service inflation is excluding energy services.
[9]The ISM non-manufacturing PMI weakened to 55.1 from 56.9, the manufacturing counterpart to 51.7 from 52.1.
[10]Source: Conference Board Consumer Sentiment https://www.conference-board.org/data/consumerconfidence.cfm as of 7/16/19
[11]Sufficient in terms of its ability to keep up with changes in demographics – e.g. the unemployment rate remains constant.
[12]The ratio is defined as total jobs openings (JOLTS) divided by people unemployed (Household Survey).

Naturally both elements are higher in the tradable goods-producing sector and likely to be lower in the non-tradable service sector[13]. In a globalized world, goods-producing companies have tended to face increasingly global, therefore higher, competition. This has exerted downward pressure on prices and lowered wage growth.

The introduction of trade barriers, might for example reduce competition in markets for tradable goods, benefitting some employees working in those sectors. Given the high degree of interlinked supply chains nowadays, the costs to reallocate production capacities are likely to be even higher – increasing the longer-term costs of trade disruptions. We remind ourselves what kind of event was needed to kick-off the latest major reorganization of globalization: the great financial crisis of 2008.

We also think that some other dynamics are at play. Powell's argument, that there is still slack in the labor market and that the natural rate of interest is lower, provides the Fed with the freedom to ease monetary policy by the design of those concepts. Neither variables are readily observable and each must be inferred from theoretical models. Simply pointing to the non-accelerating inflation rate of unemployment (NAIRU) cannot ensure the Fed's assessment of the situation is correct, even if it provides a convenient excuse to cut interest rates when economic data still remains robust. Also, the Fed has been missing its inflation target of two percent for a considerable time now.[14] As a consequence, academics, politicians and market participants alike heavily criticized the Fed. A first step to counter this and to restore credibility of the inflation target, was a well promoted policy-framework review which should officially conclude in the first half of 2020.

Which brings us back to the shift in Fed communication. If it is not the economic data, what else might explain the shift towards a more openly dovish position? One potential culprit is developments across the pond. European Central Bank (ECB) President Draghi surprised markets with his highly dovish comments just after the June FOMC meeting, effectively hinting another round of easing ahead for the Eurozone. Of course, such a competition between central banks of who can do more and faster risks spinning out of control, and might be interpreted quickly as some sort of currency war. We caution that markets may be getting ahead of themselves in betting on such an outcome, also based on some of the political noises coming out of Washington. A race to the bottom – intended by the central bank or not – would be risky for all. Given the world economy's imbalances, it would represent a huge gamble with plenty of unknown and unintended consequences.

All in all, we still expect the Fed to cut rates by 25bps in July to preemptively support the economy, but stop well short of some of the wilder market hopes. For the time being, we believe that recent data does not support more than a 25bps interest-rate cut. We further expect that the discussions about the roots of weak inflation and central-bank independence will intensify. It will be a tightrope act for the Fed to guide markets: to provide just enough support to counter trade-war related risks without inducing expectations of a major easing cycle ahead.

[13]Competitiveness of a firm and marginal productivity of employees is better observable in the goods-producing (tradable) sector than in the service sector. In the latter, increases of productivity tend to be limited – looking ahead, new technologies (e.g. digitalization, artificial intelligence) could boost this however.
[14]Basically since the formulation of the two percent target in January 2012 to be precise.

GLOSSARY

Accommodative
The aim of an **accommodative** monetary policy is to support the economy by means of monetary expansion.

Balance sheet
A **balance sheet** summarizes a company's assets, liabilities and shareholder equity.

Basis point
One **basis point e**quals 1/100 of a percentage point.

Central bank
A **central bank** manages a state's currency, money supply and interest rates.

Consensus estimate
A **consensus estimate** is a figure that depicts the average of different analysts' estimates about the performance of a particular asset.

Consumer price index (CPI)
The **consumer price index (CPI)** measures the price inflation as a percentage, year over year, of a basket of products and services that is based on the typical consumption of a private household.

Dove
Doves are in favor of an expansive monetary policy.

European Central Bank (ECB)
The **European Central Bank (ECB)** is the central bank for the Eurozone.

Eurozone
The **Eurozone** is formed of 19 European Union member states that have adopted the euro as their common currency and sole legal tender.

Federal Open Market Committee (FOMC)
The **Federal Open Market Committee (FOMC)** is the committee that oversees the open-market operations (purchases and sales of securities that are intended to steer interest rates and market liquidity) of the U.S. Federal Reserve.

Financial crisis
The **financial crisis** refers to the period of market turmoil that started in 2007 and worsened sharply in 2008 with the collapse of Lehman Brothers.

G20
The **Group of 20** are the largest industrialized and emerging economies in the world.

Headline inflation
Headline inflation is the raw inflation figure based on the consumer price index (CPI) and not adjusted for seasonality or for the often volatile elements of food and energy prices.

House of Representatives
The United States **House of Representatives** is a legislative chamber consisting of 435 Representatives, as well as non-voting delegates from Washington, D.C. and U.S. territories. Representatives are elected for two-year terms and each state's representation is based on population as measured in the previous Census.

Inflation
Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

Monetary policy
Monetary policy focuses on controlling the supply of money with the ulterior motive of price stability, reducing unemployment, boosting growth, etc. (depending on the central bank's mandate).

Non-Accelerating Inflation Rate of Unemployment (NAIRU)
The **Non-Accelerating Inflation Rate of Unemployment (NAIRU)** refers to a level of unemployment below which inflation accelerates.

Purchasing Managers Index (PMI)
The **Purchasing Managers Index (PMI)** is an indicator of the economic health of the manufacturing sector in a specific country or region.

U.S. Federal Reserve (Fed)
The **U.S. Federal Reserve**, often referred to as **"the Fed"**, is the central bank of the United States.

United States Congress
The **United States Congress** is the legislature of the federal government. It is comprised of the Senate and the House of Representatives, consisting of 435 Representatives and 100 Senators.

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