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ECONOMIC TALKING POINTS

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A July Rate Cut by the Fed Would Be A Mistake

Will the Federal Reserve lower rates at the end of this month?

The futures market certainly thinks so and Jay Powell's testimony this morning has not swayed those expectations.

But *should* they cut rates in July? Absolutely not! There is no economic justification for such a step now.

In testimony today, the Fed chairman cited the ongoing trade war between the US and China as a major reason for global economic weakness. It has hurt manufacturing output and caused havoc with supply chains. But Powell also hinted these troubles may warrant an easier monetary policy, which means the Fed may cut as soon as the end of this month.

We believe lowering the fed funds rate in July is not just premature, it may actually do more harm to the economy.

How could this be?

For one, there is little to suggest this business cycle is struggling. Most key macroeconomic indicators are still flashing green. The labor market is doing quite well. Joblessness in June stood at 3.7%, near its 50-year low. Payrolls last

month surged by 224,000, beating virtually all forecasts, and employers are still struggling to fill 7.3 million job vacancies.

Consumers seem upbeat as well about job security and income. They have accelerated spending in the second quarter and that has to be encouraging. These are not symptomatic of an economy breathing hard. Simply put, there is little to suggest this expansion is in danger of being derailed.

So what is the Fed so worried about?

Some point to concerns about the inverted yield curve. Historically, it has been a uniquely accurate metric that would foreshadow a recession. But the predictive validity of the yield curve has been greatly compromised by massive central bank purchases of sovereign debt. Such artificial distortions did not exist in previous cycles, which made the yield curve a more valuable tool.

If we set aside the yield curve, none of the typical precursors that warn of a recession are present.

What of the Fed's concern that inflation is still stuck well below its 2% symmetrical target?

Let me make two quick points here.

First, the Fed's primary gauges on price behavior – the PCE price index and core PCE --- have actually been creeping higher in recent months, though it may require a jeweler's loupe to see it. Headline PCE inflation has inched up to 1.5% in May, from 1.3% in February. Core PCE inflation rose to 1.6% in May versus 1.5% in March. True, these are not earth-shattering changes, but there is enough to see they are moving in the right direction, although not always in a straight line.

There is a second important factor to consider regarding inflation. What's keeping prices at bay is not a dangerously anemic economy or tight monetary policy --- but unprecedented structural changes in the dynamics that influence retail prices. Imagine for a moment a tug of war between forces pushing prices higher versus those driving it lower. It is abundantly clear the latter has a greater impact on the direction of inflation.

But, again, it has nothing to with interest rates being too high. Instead blame the muted inflation numbers on eCommerce, globalization, a healthy dollar, improved productivity, changing demographics, moderate energy prices, and the diminishing impact of collective bargaining agreements. Together they have significantly offset the impact of rising wages, higher tariffs and attempts by retailers to test their pricing power.

The one major sector of the US economy that has been underperforming is business. We do not expect to see a significant pick up in capital expenditures this year precisely because of the uncertainties over trade and pressure to reroute supply chains.

The G-20 meeting between President Trump and Xi Jinping accomplished little to end the trade war. The two sides are still far apart and neither is willing to capitulate. Trump has little incentive to soften his stance against China so long as the US economy is doing well and the stock market remains near record highs.

And Xi Jinping shows no sign of caving in, especially when the country plans to celebrate the 50th anniversary of its founding later this year, an event that symbolizes China's liberation from foreign exploitation. It is increasingly apparent that Beijing's main strategy in trade talks with the US is to bob, weave, duck and stall for as long as possible, or at least until after the US Presidential elections.

And let's not stop with China. The White House has threatened to raise tariffs also on goods from Europe, India, Vietnam and others. These are all worrisome issues.

But reversing the course of interest rates this month will change nothing. Keep in mind the "real" (inflation-adjusted) fed funds rate is already less than 1%! Another 25 or 50 basis point at this juncture will do little to boost economic growth and accelerate inflation---especially when the headwinds impeding growth are geopolitical in nature.

Indeed, lowering rates too soon may actually endanger this business cycle. It will force investors and lenders in the shadow-banking sector to take far more risks in a desperate search for higher returns. The chance of an asset bubble could thus increase exponentially.

Finally, there is just no urgency for the Fed to act. Indeed, we believe this expansion still has legs. Certainly the White House has been blunt in pushing for lower rates. But they have offered no economic reason that would justify such a step. What is clear is that another rate cut now would leave the FOMC with fewer resources to fend off a recession in the future. We hope the Fed will ignore the political pressure and look beyond July to conserve its monetary toolkit.

United States

	I 2018	II 2018	III 2018	IV 2018	I 2019	II 2019	III 2019	IV 2019	I 2020	II 2020	III 2020	IV 2020	I 2021	II 2021	III 2021	IV 2021
Real Gross Domestic Product (GDP):																
%	2.2	4.2	3.4	2.2	3.1	1.6	1.9	2.0	1.3	2.0	1.8	2.0	2.2	2.4	2.5	2.5
Personal Consumption Expenditures:																
PCE %	0.5	3.8	3.5	2.5	0.9	1.7	1.3	1.9	1.2	1.9	1.7	2.0	2.0	2.7	2.8	3.1
Inflation, end of period, year-over-year:																
CPI %	2.4	2.9	2.3	1.9	1.9	2.0	2.1	2.3	2.2	2.0	2.0	2.2	2.5	2.7	2.7	3.7
Unemployment Rate (end of period):																
%	4.1	4.0	3.7	3.9	3.8	3.7	3.6	3.5	3.8	3.9	4.0	4.2	4.1	4.0	4.0	3.9
Non-farm Payrolls, monthly avg. thousand:																
	228	243	189	233	174	171	165	155	125	115	105	100	115	125	155	165
Treasury 10-yr Note Yield % (end of period):																
	2.74	2.85	3.06	2.76	2.42	2.00	2.30	2.20	2.15	2.35	2.45	2.85	3.20	3.50	4.10	4.40
Federal funds rate % (end of period):																
	1.63	1.88	2.13	2.38	2.38	2.38	2.13	1.88	1.88	1.88	1.88	1.88	2.13	2.38	2.63	2.63

GDP Growth - Global Economy

Country	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
US	2.6	1.6	2.2	1.8	2.5	2.9	1.6	2.2	2.9	2.2	1.8	2.4
Eurozone	1.7	1.4	-0.9	-0.3	1.2	1.6	1.7	2.5	1.9	1.3	1.4	1.8
United Kingdom	1.7	0.7	0.3	1.8	2.9	2.2	1.9	1.8	1.4	1.4	0.8	1.6
Japan	4.6	-0.4	1.6	1.5	-0.1	1.1	1.0	1.9	0.8	0.5	0.4	1.1
Canada	3.1	3.1	1.7	2.2	2.5	0.9	1.4	3.0	1.9	1.5	1.3	2.2
India	8.4	8.6	6.7	4.9	7.4	8.0	8.1	7.2	6.8	6.8	6.5	7.3
China	10.5	9.5	7.8	7.7	7.3	6.9	6.7	6.8	6.6	6.2	5.9	6.5
Brazil	7.5	2.7	0.9	2.3	0.1	-3.5	-3.5	1.4	1.1	1.2	1.2	1.7
Mexico	5.2	4.0	3.9	1.4	2.3	2.7	2.9	2.1	2.0	1.3	0.9	2.1
Australia	2.8	2.6	3.6	2.4	2.6	2.5	2.4	2.4	2.7	2.0	1.8	2.6
Russia	4.0	4.3	3.4	1.3	0.6	-2.8	-0.2	1.6	2.5	2.0	1.8	2.4
World	4.2	3.0	2.6	2.9	3.0	2.8	2.6	3.3	3.2	3.0	2.7	3.3

Economic & Geopolitical Risks to Monitor

Projections are for 2019 and 2020

PROBABILITY	U.S.
HIGH	U.S. settles on interim trade deal with China in 2H 2019. Threat of a broader tariffs recedes.
HIGH	Strains emerge between Trump and USTR Lighthizer as China hawks in WH lose influence.
Moderate	Fed expected to reduce rates twice in 2nd half of 2019, each 25 basis points. No cuts seen in 2020.
HIGH	10 Yr. Treasury yield rebounds sharply in 2020 as investor appetite for US federal debt decreases.
HIGH	U.S. firms slow CAP EX in 2019 given global economic slowdown, trade tensions and record corp. debt.
Moderate	U.S. economy suffers a two-quarter contraction by 2020.
	FOREIGN
HIGH	Venezuela's Maduro regime collapses in 2019; new elections are planned.
HIGH	China successfully arrests economic slowdown by using selective stimulus.
Moderate	Risk of military confrontation in South China Sea escalates as US increases naval presence.
HIGH	Terrorist attempts to sabotage Saudi oil infrastructure increases in 2019. Oil prices climb.
HIGH	Iran counters U.S. sanctions by taking actions that raise tensions in the Middle East.
HIGH	Boris Johnson most likely to be next PM; Will pull UK out of EU by October with or without deal.
Moderate	Global demand for US WTI oil rises as conflict in the Persian Gulf disrupts shipments of crude.