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ECONOMIC TALKING POINTS

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Will the Fed Succumb to White House Pressure?

The Federal Reserve will likely cut rates by 25 basis points this week. If so, there is a technical term for such a policy move --- capitulation!

For the first time since the 1970s, pressure from the White House will have permeated monetary policy. That's because from a purely economic perspective, there is no need for any rate reduction at this time. GDP growth has been humming along at a better than 2.5% pace so far this year.

Of course, those on the FOMC will vociferously reject the notion it has surrendered to wishes from the White House. Fed officials have repeatedly expressed concerns about the slowdown in foreign economic growth and the headwinds caused by trade tensions. What is needed, they argue, is a bit of an insurance policy to prevent a recession in the US and avoid a bout of deflation.

But to be honest, that explanation has something of a tin sound to it.

First, the real fed funds rate (nominal minus inflation) is already less than 1%. So it's unclear what another 25 basis point reduction could do.

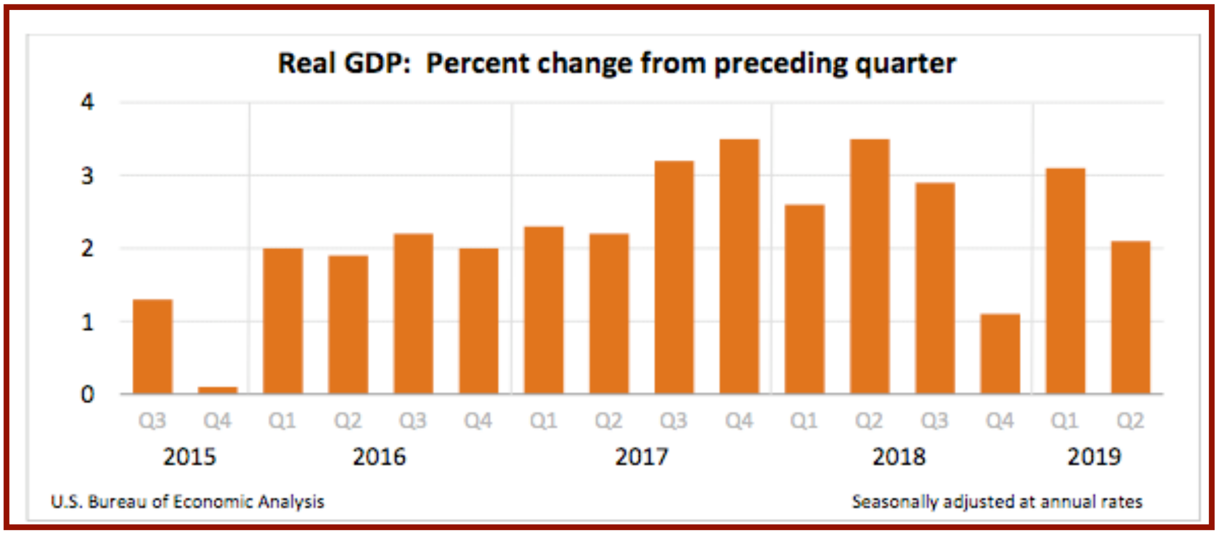
The fundamental risk facing the US economy is NOT that interest rates are too high. It's that the White House has rattled the world economy with its frontal assault on globalization in pursuit of policies that favor protectionism. In less than two years, the Trump administration has uprooted decades of unassailable evidence that globalization works for both consuming and producing nations--- and that protectionism does much more harm than good.

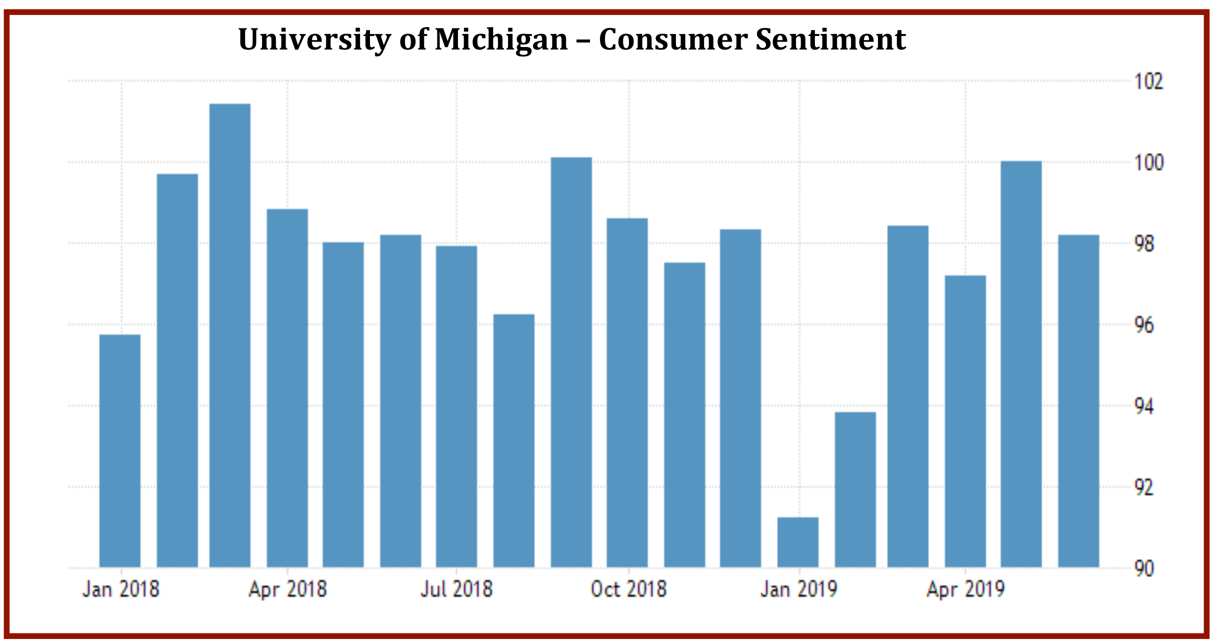
That lesson was most painfully learned in the 1930s. Using tariffs as an economic weapon greatly exacerbated the Great Depression. But as the

German philosopher Friedrich Hegel observed: "The one thing we learn from history is that we learn nothing from history!" Sadly, today's policymakers at the White House seem to have an historical memory that goes back to breakfast.

Should the Fed go ahead and lower the benchmark rate, it would mark yet another disturbing departure for this central bank. Time and time again the Fed's mantra has been that it is data dependent when deliberating on monetary policy. But I'm afraid that "data dependent" phase is about to become a vacuous utterance since there is ample evidence the economy is enjoying considerable forward momentum.

Consumers have significantly ramped up spending in the latest quarter and confidence remains near record highs. Wages are still climbing faster than wages, boosting purchasing power. Companies are also hiring aggressively. Do we need to cite again that the jobless rate is holding at its lowest level in nearly half a century?





Even the Fed's own Beige Book notes as much!! The report, which was released July 17th, is fairly sanguine on the economy. Posted below are some excerpts from its opening section.

• "Economic activity continued to expand at a modest pace overall from mid-May through early July, with little change from the prior reporting period. In most Districts, sales of retail goods increased slightly overall, although vehicle sales were flat. Activity in the nonfinancial services sector rose further."

• "Manufacturing production was generally flat, but a few Districts noted a modest pickup in activity since the last reporting period."

•"The outlook generally was positive for the coming months, with expectations of continued modest growth, despite widespread concerns about the possible negative impact of trade-related uncertainty."

These observations from Fed's district banks hardly create a sense of urgency for the first rate cut in a decade!

While there has been a slump in business capital spending, it's no mystery why. The trade war with China and the scatter shot threats to raise punitive tariffs against Europe, India, Vietnam and others have caused havoc to supply chain routes and disrupted years of carefully crafted relationships with international suppliers. You don't have to be a rocket scientist to see how this would damage global trade and depress economic activity. But lower rates WILL NOT rectify that.

It's important to remember that capital spending is a multi-year planning process. With the future so murky on trade, tariffs and foreign economic activity, it is difficult for corporate leaders to decide on how, when and where to deploy capital. It's not that CEOs seek certainty about the future. They just hope for less unpredictability from the White House.

Most visible in the last few days has been the President's repeated tweets haranguing the Fed for not doing as much as Europe and Japan to lower rates. It is true the European Central Bank and the Bank of Japan have their benchmark rates at 0% and -0.1%, respectively!! So here's a question: How well have those ultra low rates worked for them? Not much. Both have revised their forecasts to show slower growth this year.

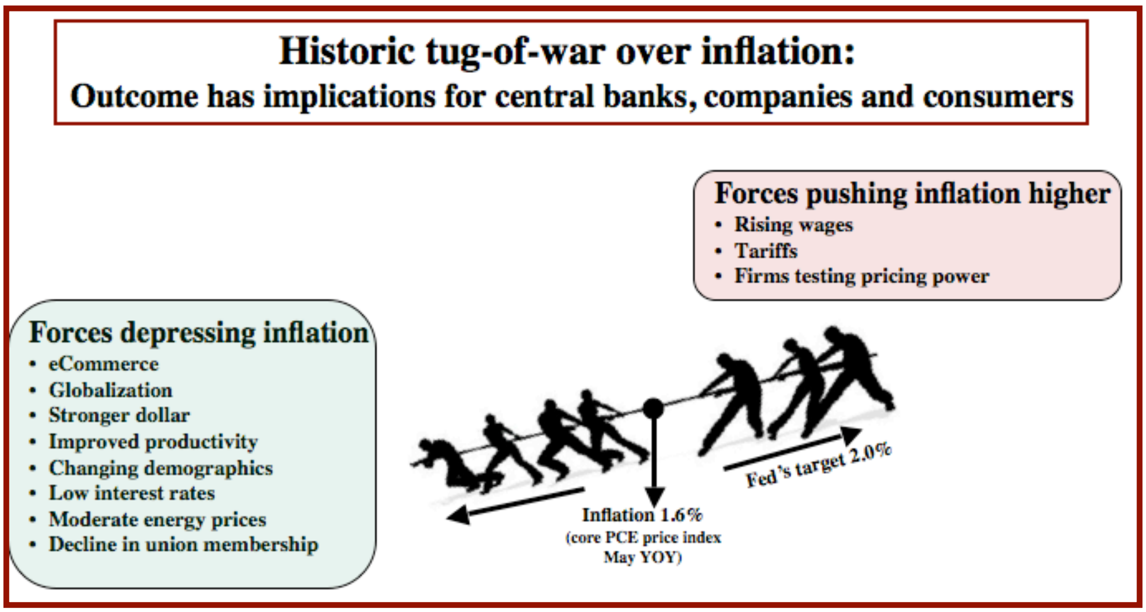
It highlights the limits of what monetary policy can do. At some point slashing rates become useless when governments pursue self-injurious policies. In this case it is the collateral damage done when the two largest economies in the world are engaged in a testosterone-raging trade war.

In fact, lowering rates now can perversely endanger financial stability by forcing investors and nonbank lenders to take on far greater risks to earn higher returns, not to mention how it also devastates savers.

Again, the main roadblock to faster growth these days is not tight monetary policy. It's the reckless way this administration has weaponized tariffs as a way to carry out economic and foreign policies.

Perhaps the Fed's biggest concern is how inflation seems perennially stuck below their 2% target. Should a recession strike, it might lead to deflation, which can be terribly destructive to an economy.

But it is hard to see how lower rates will fire up prices this time, since it is technology that has fundamentally altered the dynamics of price behavior. There's a Herculean tug of war underway between forces driving inflation higher versus those pulling it down, and it is abundantly clear the wining side has been the latter.



Higher wages, tariffs and efforts to test pricing power have been completely overwhelmed by the disinflationary forces of eCommerce, globalization, productivity, a strong dollar, modest oil prices and fewer collective bargaining agreements. eCommerce alone is proving to be the single greatest deflationary force in modern economic history.

Cutting the benchmark rate now, we believe, would be an act of folly. It would make a mockery of future assurances that the Fed is "data dependent." Worse, it raises the specter that the Fed finally caved in to the convoluted economic tweets from the White House.

(Forecast tables)

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	2.1	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	1.4	1.1	4.3	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	1.6	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

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