Here's why the Fed's coming rate cut makes no sense

Andy Serwer with Max Zahn

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I’m not much of a Fed watcher (never mind a Fed basher), but in my 35 years of covering the financial markets, I’ve never been more vexed by what our central bank is up to.

The disconnect is this: Fed Chair Jay Powell is strongly signaling he will cut interest rates at the end of the month, and for the life of me I can’t figure out why.

The way I’ve always understood it, the Fed is supposed to cut rates when the economy needs a boost. But how in the world do you argue that right now? Unemployment is at a record low, the stock market is at a record high (more on that in a minute), and the economy is purring right along.

Our economic system is not in need of help.

Here’s what Powell himself delivered in written testimony to Congress last week: “The labor market remains healthy ...the unemployment rate moved down...to 3.7 percent in June, close to its lowest level in 50 years. Gross domestic product increased at an annual rate of 3.1 percent in the first quarter of 2019, similar to last year's pace.” Powell went on to call this a “strong reading.”

Unemployment at 3.7% and GDP growth at 3.1%? I can’t remember when these two numbers were that close.

How can Fed Chair Powell possibly reconcile these robust readings—which he himself cites—with a rate cut?

And then there are the anecdotes.

If you travel around the country now you see new construction, shiny late-model cars and trucks, and all kinds of help-wanted signs. You see college graduates getting jobs. You see packed highways and airports. You see housing prices, rents and commercial real estate relatively strong, not just in Manhattan and tech hubs, but across the nation. I know there are pockets of weakness out there, but ladies and gentlemen, this is not an economy in need of goosing.

Need more convincing? Ask CEOs. Here's Ed Bastian, CEO of Delta, talking about his business last week: "We're growing at a multiple of GDP, particularly in the U.S.," he said. "Top-line revenues were up 9% in the quarter. That's a trend line we've been seeing in the last couple years."

Maybe not surprisingly, then, we now hear talk that this rate cut should be considered preemptive or "an insurance cut." Seriously? That's the new modus operandi of the Fed? Seems a long way from the bank's dual mandate of maximizing employment—done—and stabilizing prices—not an issue. (See my take on the Fed's inflation delusion.)

"The main reason why I don't believe it's urgent to cut rates is because the economy is still fundamentally sound," says **Bernard Baumohl, Chief Global Economist at The Economic Outlook Group.** "I don't see what good a 25 basis point cut in rates will do at this time."

Amen, Bernard.

The economic issues

Are there worrisome economic issues out there? Of course. Always. At the top of the list are global trade frictions (or "crosscurrents," as Chair Powell likes to call them) which in fact are having an impact on global growth. But why is that occurring? Almost entirely because President Trump is forcing the issue with China, Europe, Canada, Mexico, and now maybe India. In a sense then, the Fed chair has become (and yes, unintentionally) Trump's enabler.

Here's Trump's "house money" thought process: "The U.S. economy is in great shape. That means I can call out these other lame-o countries on trade. And if it hurts our economy, Powell will cut rates."

I’d make the same argument with regard to the president’s confrontational policy with Iran.

To take this a step further, is it the case that because President Trump is so unpredictable, we, generally speaking, need lower rates during his tenure to mitigate that uncertainty?

I’ll let you chew on that one.

As Bank of America recently noted, “The Fed seems to be willing to dismiss the better data from the US and instead is focusing on the weaker global data. Indeed, when Powell was asked if the strong [June] jobs report changed his views on cuts, he stated ‘no’.”

(Well then…)

The stock market

Now let’s return to the positively giddy stock market for a moment. Ask any investor why the market is up recently and they will reply, “Because Powell’s going to cut rates.” The market’s recent ascent is certainly not because of some expected earnings boon, the other primary determinant of equity prices. Earnings are projected to decline for the balance of the year.

And so here you have the market relying and counting on Chair Powell’s action. But if you think about it, isn’t the shoe really on the other foot?

Here’s the market’s “we-have-Jay-over-a-barrel” thought process: “You better cut rates in July, Jay old buddy. Stocks are way up because you promised you would. We’re counting on you. If you fail us, we’ll freak out and crash. That will make everyone mad, especially the Big Guy in the White House. Don’t blow it.”

To recap, more and more it appears that the Fed is being held hostage by 1) President Trump and his global macroeconomic policies and 2) the stock market.

There are obvious resulting problems with this, the biggest being when we really need a rate cut, i.e., when the economy really needs Rx-ing, there will be nothing left to cut. That could be seriously messy.

Another problem likely occurring is that investors will increase their appetite for risk, which Mohamed El-Erian, chief economic advisor to Allianz, recently warned of: “With easing unlikely to have much beneficial economic effects, corporate and economic fundamentals will lag further already-elevated asset prices, thereby accentuating threats of future financial instability that could cause economic harm,” he wrote.

It looks highly likely that Jay Powell & Co. will lower rates on July 31. “At this stage it would be a PR disaster if they didn’t follow through on easing,” says Jim O’Sullivan, chief U.S. economist at High Frequency Economics. Of course the market shows a 100% probability of that happening.

When Powell does, though, I’ll still have that same question.

Why in God’s name, man? Why?

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