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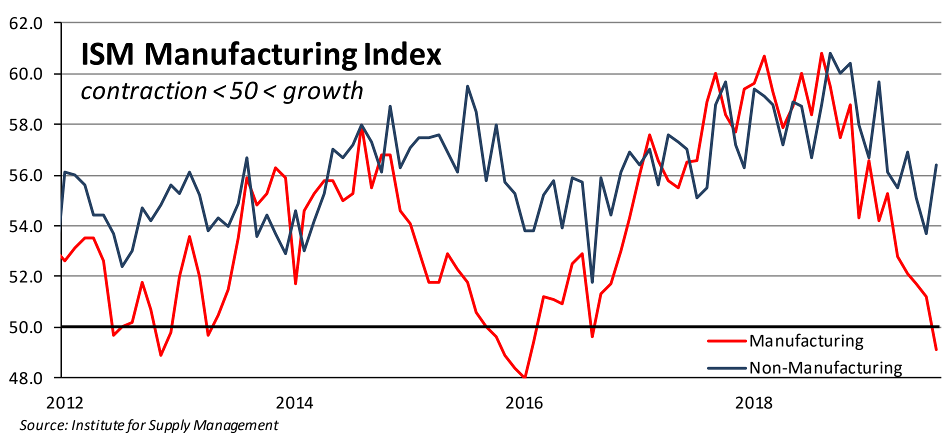
ECONOMIC WEEKLY

25 or 50?

Judging from the shape of the yield curve and fed funds futures, the Fed has about six months to cut rates 100bp or the economy is at risk of recession. A 50bp rate cut in September would be a great start. Threats to growth could be resolved, of course, reducing the need for rate cuts, but surveys suggest a hard slowdown is inevitable over the next few months, even if it's not entirely obvious in the next few weeks' data. Besides, inflation is so low, there is less risk in possibly cutting rates too far than there is in possibly keeping rates too high. The Fed can act quickly and aggressively, as New York Fed President Williams suggested is the appropriate course when the economy stalls and the fed funds rate is low[1]. Then, it can reverse course if necessary.

Around the world, central banks are following the Fed's lead and cutting interest rates, but it's not working yet. PMIs, including the US manufacturing index, continue to show the world economy is losing steam. In the US, the Fed has committed to using monetary policy to keep the expansion going as long as possible to pursue full employment and stable inflation. The market interprets that commitment to mean the Fed will cut rates in September, most likely by 25bp. And, there is a growing possibility of a 50bp cut in market thinking.

This week, we consider what to look for to determine whether they will cut 25bp or 50bp. At the moment, a quarter-point appears more likely, as Nick Timiraos notes in *The Wall Street Journal*. But there are still important economic reports between now and the meeting. Plus, the critical thing is not necessarily doing 50bp at the September meeting in two weeks, but doing 50bp quickly. There's still October 30, after all.



1 In last month's speech. Excerpts from this month's speech are discussed later.

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ECONOMICS

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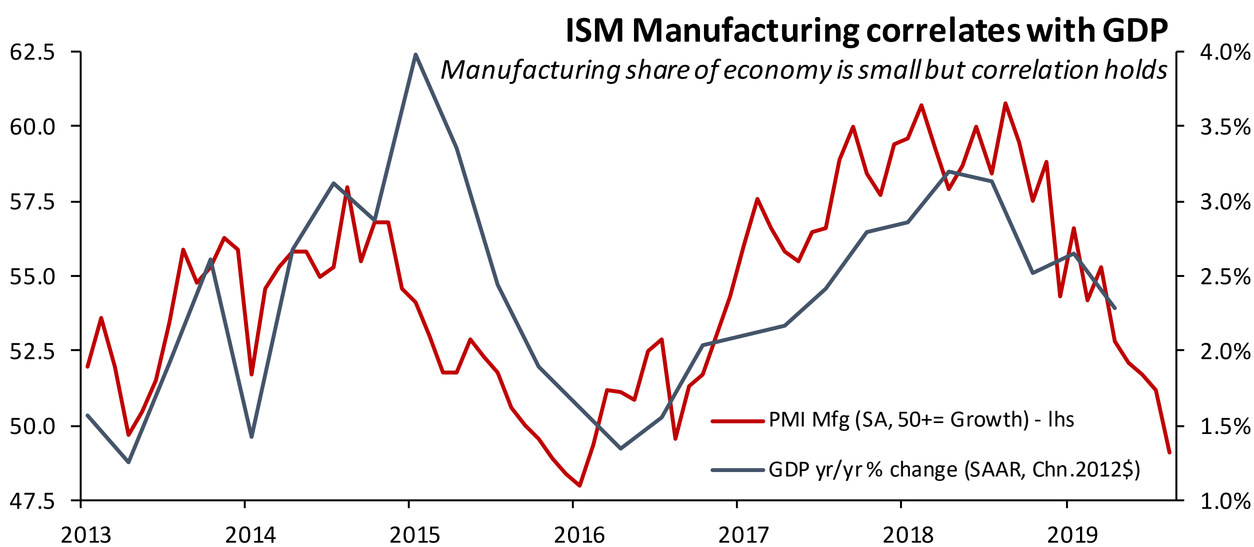
Are they following the latest data?

The Fed staff and FOMC use quarterly data for their primary analysis. By the time the September meeting rolls around in two weeks, quarterly analysis will be based on growth, employment, and inflation data that is 3-6 months stale. For that reason, it often makes sense to approach Fed analysis without paying too much attention to the latest information. But once the Fed notices and begins to act against a slowdown, participants tend to consider more recent data.

That said, perhaps the most striking thing to emerge from the July 31 FOMC minutes, despite a rate cut, was not one participant was concerned about economic growth. That could change at the next meeting, as i) growth in aggregate hours worked has slowed to less than 1% year-on-year; ii) ISM manufacturing is below 50; and iii) personal income grew 0.1% in July (over June) vs 0.3% expected. The Fed staff builds its consumption forecast from income growth.

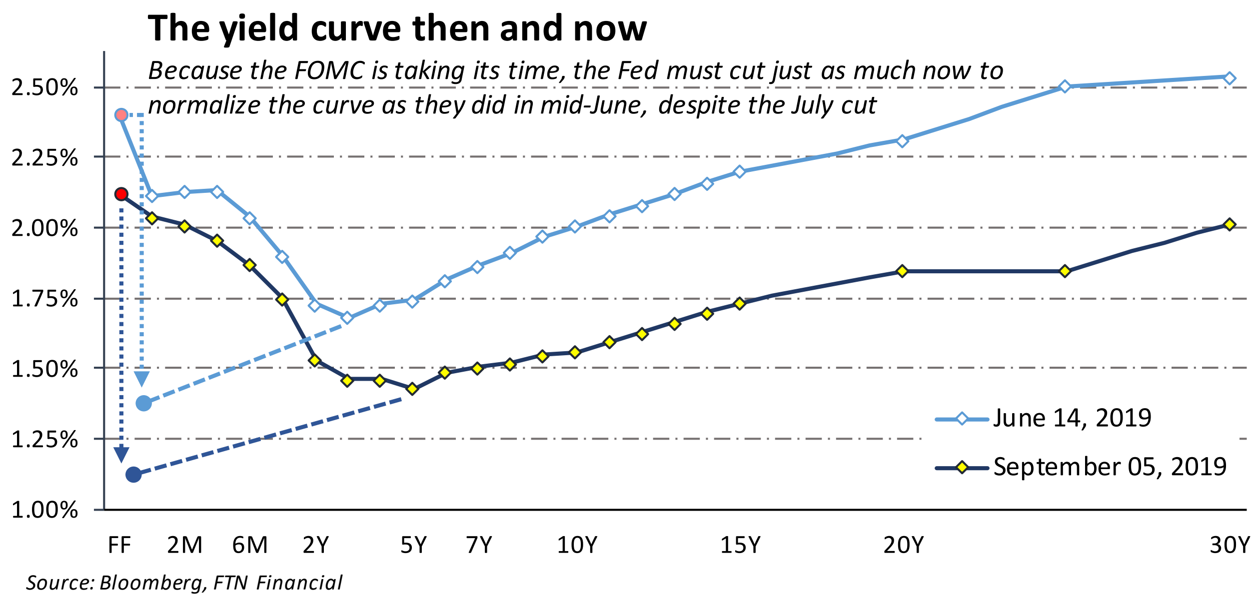
Rapid deterioration in the ISMs has prompted Fed easing in the past. Greenspan cited the ISMs in the mid-90s, for instance. Since then, officials have downplayed the manufacturing index because manufacturing's share of the economy has shrunk. And yet, manufacturing ISM continues to correlate with GDP growth better than the non-manufacturing index. Besides, as seen in 2015-16, manufacturing leads, non-manufacturing lags. Waiting around for the broad economy to catch up with a weakening manufacturing sector is like standing around in a coalmine waiting to see if maybe the canary is merely suffering from asthma.



Source: Institute of Supply Management, Bureau of Economic Analysis, Haver

Do they respect the curve?

The Fed has a love/hate relationship with the yield curve. Staffers consider it a recession indicator and a guide to appropriate policy. Some have written papers suggesting alternatives to the traditional idea 2-yr to 10-yr inversion signals a recession, including a comparison of 3-mo to 18-mo rates. All of these measures are inverted now, however, rendering these disagreements moot. In a speech last week, St. Louis Fed President James Bullard promoted yield curve normalization to the number-one priority of the Fed. In the same speech, he said he has no interest of hearing excuses from other participants convinced "it's different this time."



As the chart shows, since the Fed first talked about cutting rates, market yields have fallen faster than the Fed has adjusted fed funds. A 50bp cut would be a good first step toward getting back in front of the market. Hence, if other participants start talking about the importance of the curve, or if they recognize the drop in yields, as, for example, Dallas Fed President Robert Kaplan did, calling it "ominous," the odds of a 50bp cut will increase.

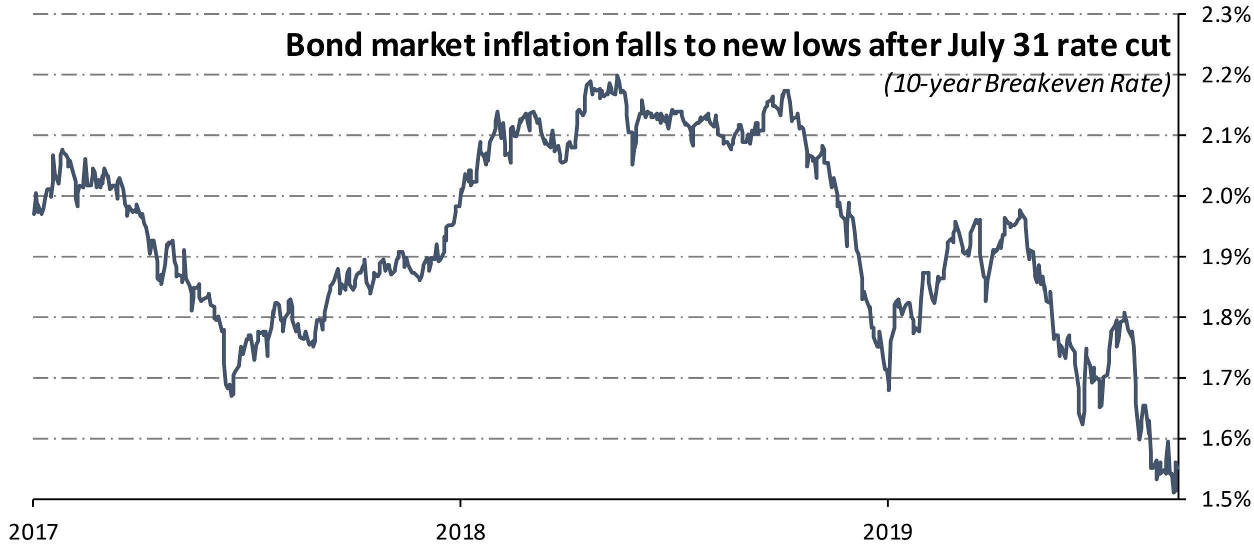
Do they recognize the freedom granted by low inflation?

Chair Powell recognized the two mid-cycle easing experiences of 1995 and 1998 as precedents for the rate cut in July, but he has not yet recognized another strong parallel to the mid-90s. Then, as now, inflation was low. Low inflation not only gives the Fed reason to cut rates, as seen in the July 31 minutes, it also gives the Fed insulation against a mistake. **As Greenspan noted in 1995, inflation was low enough that the Fed could always reverse course if necessary without out of control inflation.** Greenspan was right. The Fed cut rates 75bp in 1995-96, raised rates in '97 and cut again in '98. Inflation fluctuated, but never took off.

NY Fed President John Williams, in his Wednesday policy speech, said, "Persistently low inflation is a key area of my attention." He went on to explain:

> "On its own, inflation somewhat below our longer-run goal would not be such a big deal, especially with our economy strong. But the broader context is important. Ongoing disinflationary pressures from abroad, and the risk that inflation expectations in the U.S. may have drifted down after many years of inflation running below 2 percent, form an important part of this picture."

If other policy makers are also concerned about inflation expectations, fresh three-year lows in bond market inflation expectations after the July 31 rate cut suggest the Fed still has work to do to shift traders' conviction low inflation is here to stay.



Source: Bloomberg

Greenspan's mid-90s inflation-based argument is even more valid now than it was then. The Greenspan Fed targeted true price stability, or 0% inflation. The modern Fed has redefined price stability as 2% inflation. Inflation was actually 150bp above the Fed's target in the mid-90s, but Greenspan was smart enough to realize inflation's cyclicality. He knew inflation would fall in the next recession, and was unlikely to fall much until then.

Now, many Fed participants seem to be convinced there is no cyclicality in inflation, meaning they are not worried about it falling in the next recession. As a result, a considerable number of participants seem to think inflation at 1.4% is "close enough" to the 2% target to preclude any rate cuts. Williams makes the case for taking low inflation more seriously.

What are they hearing from business contacts?

One reason the Fed cut rates in July was a global confidence shock. Chair Powell emphasized business confidence in his July testimony and feedback from local business contacts has been featured in the Fed minutes and in participants' speeches since. If participants continue to hear uncertainty from business contacts, it raises the odds of a more aggressive policy response.

This week, Williams told his New York audience, "On our own shores, concerns around trade policy with China are adding to an uncertain picture. My contacts in the business community have said this is making them more cautious about investment. The effects of this angst are already showing up in the investment numbers."

The Beige Book summary was more consistent with a 25bp cut than 50bp, though there was deeper concern in district reports than in the summary. In the seven of 12 districts where respondents mentioned trade tensions, they were negatively affecting business decision making. Manufacturing weakened in eight of 12 districts and was flat in one. And districts that track agriculture were universal in reporting trouble, though the degree of trouble varied. The same is true of energy producing districts. Nevertheless, retail is still growing in most districts, though it has slowed in most, and employment is growing at least modestly in eight districts and flat in the rest.

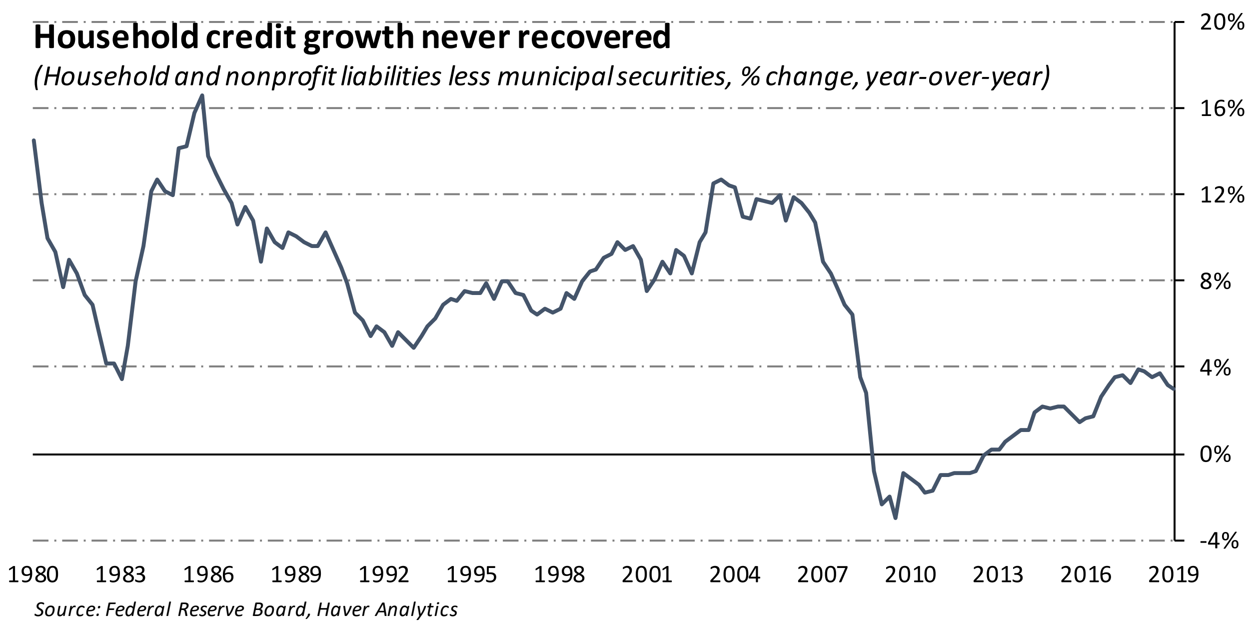
Are participants still talking about "additional accommodation?"

The combination of quarter-point-per-quarter rate hikes and balance sheet reduction amounted to about 350bp of tightening in 2017 and 2018, based on Fed estimates of the impact of QT. That's about typical for Fed tightening cycles since 1980, all of which proved excessive in the end. And yet, the Fed still talks about providing additional accommodation, as if its current policy stance is already accommodative.

The best-known Fed estimate of the real neutral fed funds rate — the Laubach-Williams estimate — is 0.80%. Inflation is 1.4%. Based on this, the neutral fed funds rate is 2.2%, suggesting the current 2.0-2.25% range is neutral. But the Laubach-Williams estimate is far from perfect. It is volatile and subject to constant revisions.

In 2006-2008, the r-star concept contributed to the misguided belief among participants they were providing accommodation when, in fact, policy was severely restrictive. Last quarter, it was 30bp lower than it is this quarter, suggesting volatility continues to be a problem. And in April, years' worth of estimates were cut by as much as 70bp. **When the actual funds rate is as close to neutral as calculated by the Fed's models, perhaps the best indication of which side of neutral policy is on is no longer theoretical models but actual credit behavior.**

As the chart shows, household credit was hammered by the Great Recession. It started to recover in 2010-2016. Credit growth never recovered even to previous recessionary levels, however, let alone levels achieved in past expansions. It stalled in 2017, when the Fed started tightening, and turned down this year. Nonfinancial business debt growth peaked, even earlier, in the second quarter of 2015. Some of the reduction in business borrowing could reflect the after-tax income boost from 2018's big corporate tax cut, or decisions to replace debt financing with equity financing. Still, it's hard to imagine how the Fed could think monetary policy is accommodative when nonfinancial-private-sector credit growth has slowed from a modest 5.5% to an even slower 3% since the Fed started tightening.



The problem with talking about easing in terms of providing additional accommodation rather than in terms of removing restraint is that it gives the upper hand to those resisting rate cuts. It is a lot easier to fight additional accommodation than to fight relaxing too-tight policy. Yet, credit growth is slowing. Policy is restrictive. It is time to stop pretending the Fed is accommodative.

Bottom line: Better safe than sorry

Now that the fed funds rate is in the neighborhood of neutral, Chair Powell has described the Fed's mandate in terms of risk management and ounces of prevention. Both fall under the broader umbrella of "better safe than sorry." That was Dallas Fed President Robert Kaplan's point when he warned participants this week, "If we wait for consumption to slow, it might be too late."

As Bernanke made clear years ago, sustainably higher rates would be beneficial to the economy because they would give the Fed more leeway to cut in a downturn. But he also warned the Fed cannot force rates up faster than the market will allow. Try it, he warned, and the economy will stall. Soon enough, rates would be lower than they were in the first place.

It is now clear the Fed raised rates more than it should have, especially in light of the trade uncertainty. Granted, there was no way to anticipate White House trade policy. Or, for that matter, the Chinese response. But there is no shame in reversing a mistake, especially when it was not necessarily a mistake at the time. Markets have recognized the need for a downward adjustment since last November. The Fed recognized it three months ago, but because the Fed was slow to act, it is falling behind the curve despite one quarter-point cut so far. James Bullard called for an "aggressive rate cut" in a Tuesday speech. We'll be watching the rest of the FOMC — especially the chair — to see if they agree. A 50bp cut is preferable to 25bp in two weeks. Better still would be a 50bp cut and a promise from Trump and Xi to stop escalating the trade dispute and get back to the bargaining table. Given the unlikelihood of the latter, however, the onus is on the Fed to keep the expansion alive. It remains to be seen if the majority of the committee agrees.

– Chris Low, Chief Economist

The Week Ahead

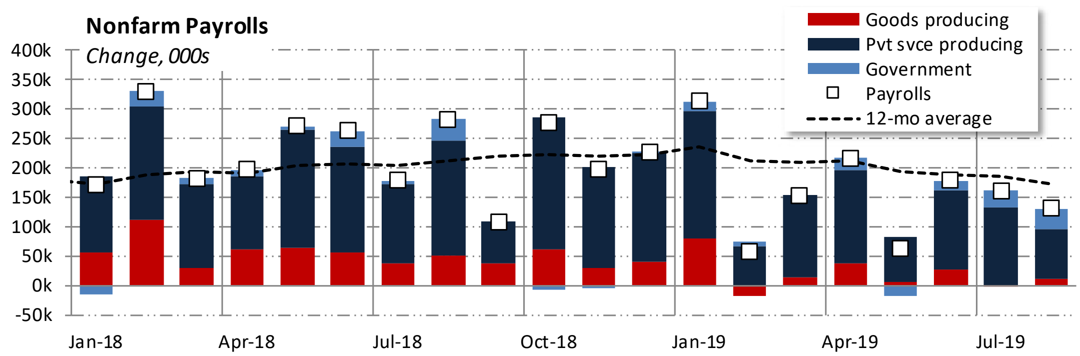
This Week's Numbers

		PRIOR	CONSENSUS HIGH	CONSENSUS LOW	CONSENSUS MEDIAN	FTN
Monday, September 9	Consumer Credit - Jul	$14.596b	$17.000b	$15.500b	$16.000b	**14.000b**
Tuesday, September 10	NFIB Small Business Optimism - Aug	104.7	104	103.5	103.5	**106.0**
Wednesday, September 11	PPI Final Demand MoM - Aug	0.2%	0.2%	-0.1%	0.1%	**0.0%**
	PPI Ex Food and Energy MoM - Aug	-0.1%	0.3%	0.1%	0.2%	**0.1%**
	PPI Ex Food, Energy, Trade MoM - Aug	-0.1%	0.3%	0.1%	0.2%	**0.1%**
	PPI Final Demand YoY - Aug	1.7%	1.8%	1.7%	1.8%	**1.7%**
	PPI Ex Food and Energy YoY - Aug	2.1%	2.2%	2.1%	2.2%	**2.1%**
	Wholesale Inventories MoM - Jul F	0.2%	0.2%	0.2%	0.2%	**0.2%**
Thursday, September 12	CPI MoM - Aug	0.3%	0.2%	-0.1%	0.1%	**0.1%**
	CPI Ex Food and Energy MoM - Aug	0.3%	0.3%	0.2%	0.2%	**0.2%**
	CPI YoY - Aug	1.8%	1.8%	1.7%	1.8%	**1.8%**
	CPI Ex Food and Energy YoY - Aug	2.2%	2.4%	2.3%	2.3%	**2.3%**
Friday, September 13	Retail Sales Advance MoM - Aug	0.7%	0.6%	-0.2%	0.2%	**0.3%**
	Retail Sales Ex Auto MoM - Aug	1.0%	0.6%	-0.3%	0.1%	**0.2%**
	Retail Sales Ex Auto and Gas - Aug	0.9%	0.4%	0.2%	0.3%	**0.2%**
	Retail Sales Control Group - Aug	1.0%	0.5%	-0.2%	0.3%	**0.2%**
	U. of Mich. Sentiment	89.8	91	90	90.5	**89.0**
	Business Inventories	0.0%	0.4%	0.2%	0.3%	**0.2%**

Review

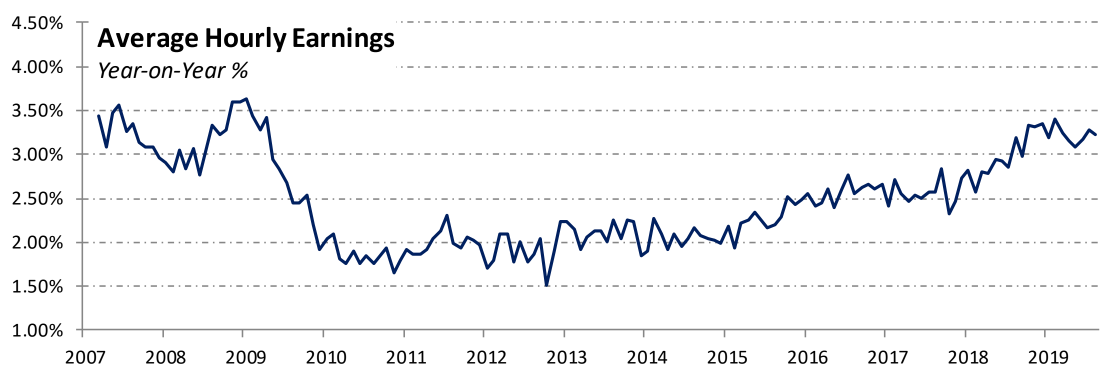
This week, nonfarm payrolls disappointed and US manufacturing reports indicated the global slowdown is beginning to impact domestic manufacturers. (Non-manufacturers remain unscathed by the slowdown, at this stage anyway.) The US and China agreed to continue trade talks for the sake of continuing talks but neither side appears ready to concede on terms.

- Nonfarm payrolls rose 130k, below the 159k consensus. With net revisions subtracting 20k jobs between June and July, the 12-month average gain trended down from a pre-revised 187k in July to 173k. Private payrolls added 96k (well below the 150k expected) and government added 34k, of which 25k represented 2020 Census workers.
    - Private service-providers added 84k jobs, with professional & business services accounting for 37k (15k were temporary workers), health care accounting for 36k, and financial accounting for 15k (nearly half were added by insurance carriers). Retail trade, impacted by the trade war shed 11.1k jobs, and education lost another 5.4k jobs.
    - The goods-producing segment added 12k with construction and manufacturing accounting for 11k and 3k, respectively. (Mining lost 5k jobs with nearly all coming from extraction, support, and supervisory roles.)



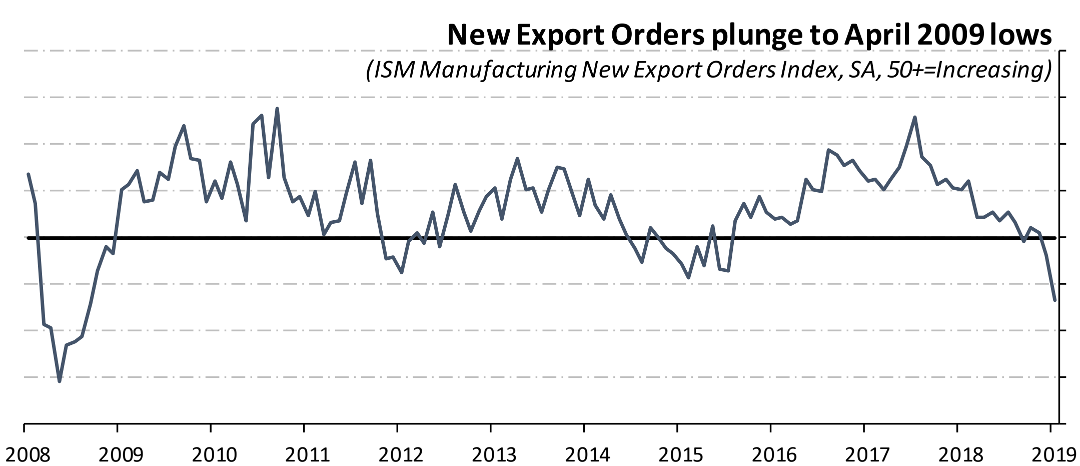
Source: Bureau of Labor Statistics and FTN Financial

- Unemployment remained at 3.7%, while the U6, which includes part-time and marginal workers, rose two-tenths to 7.2%.
- Aggregate hours rebounded from 34.3 to 34.4 as expected, and average hourly earnings rose 0.4% over the month, but due to an artificially elevated value in August of 2018, the year-over-year rate ticked down a tenth from 3.3% to 3.2%.



Source: Bureau of Labor Statistics

- Tuesday's ISM manufacturing report signaled a contraction for the first time since August 2016. The PMI fell 2.1 points from July's 50.8 to 49.1, with employment and new orders posting the largest declines. But new export orders, a subindex that does not factor into the headline number, was the overall driver of weakness, falling for the second straight month to its lowest level since April 2009.



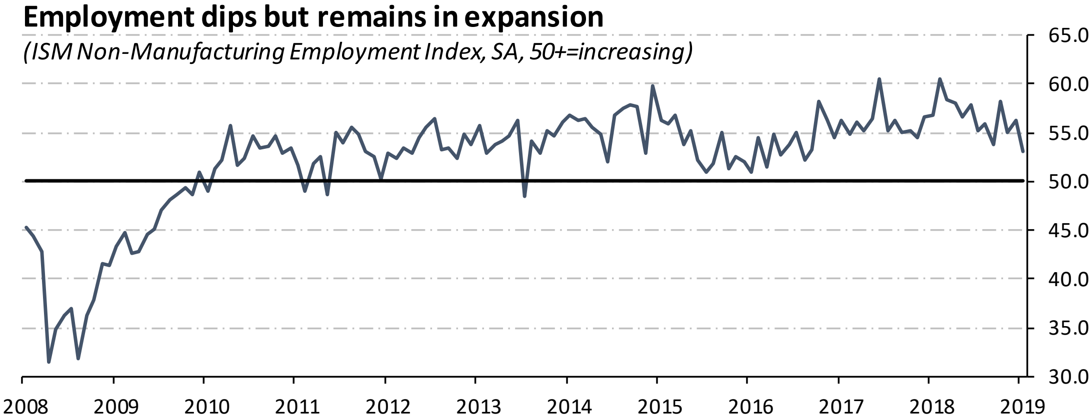
Source: Institute for Supply Management, FTN Financial

- The New Export Orders Index fell 4.8 points from 48.1 to 43.3 on softer global demand. Only two industries reported growth — furniture and food, beverage, and tobacco products — while ten reported decreases.
- Employment fell 4.3 points, from 51.7 to 47.4 with about 25% of respondents commenting negatively on employment expansion and comments regarding worker reductions were minimal. (Manufacturing accounts for about 9% of overall employment.)

- ISM Non-Manufacturing rebounded after two consecutive months of cooling. NMI rose 2.7 points, from July's 53.7 to 56.4, with 16 out of 18 industries reporting growth. Business activity and new orders posted the largest increases. Business activity rose 8.4 points to 61.5 and the new orders rose 6.2 points to 60.3.
  - Employment posted the biggest decline, falling 3.1 points, but nonmanufacturing employment continues to expand at 53.1. Ten industries reported adding labor and six reported reducing it. Some comments from respondents focused on employee turnover and adding jobs to compensate for business growth.

Employment dips but remains in expansion

(ISM Non-Manufacturing Employment Index, SA, 50+=increasing)



Source: Institute for Supply Management, FTN Financial

The Atlanta Fed's Q3 GDPNow forecast fell from 1.7% last Wednesday to 1.5% this Wednesday, driven by this week's reported trade balance slide for July. The NY Fed also revised its Nowcast lower from 1.8% to 1.55%, driven by this week's ISM manufacturing report.

Preview

Note: ★ = High Impact Event
All times Eastern Daylight

Saturday, September 7

- Germany: Chancellor Angela Merkel concludes a two-day visit to China.
- US: Defense Secretary Mark Esper holds a press conference in Paris after meeting with his French counterpart over issues related to Iran.
- China: Foreign reserves

Sunday, September 8

- Russia: Regional elections. Moscow has been facing increasing protests in support of opposition candidates barred from vote.
- 7:50pm – Japan:
  - GDP Annualized SA – Q2 F (Q2 P: 1.8% q/q; Con: 1.3% q/q)
  - GDP SA – Q2 F (Q2 P: 0.4% q/q; Con: 0.3% q/q)
- ★ China:
  - Exports – Aug (Last: 3.3% y/y; Con: 2.0% y/y)
  - Exports (CNY) – Aug (Last: 10.3% y/y; Con: 7.7% y/y)
  - Imports – Aug (Last: -5.6% y/y; Con: -6.5% y/y)
  - Imports (CNY) – Aug (Last: 0.4% y/y; Con: -2.9% y/y)
  - Trade – Aug (Last: $45.06b; Con: $42.45b)

Monday, September 9

- ★ UK: Brexit Impasse. Parliament may be suspended and a bill blocking a no-deal Brexit could become law. The bill would derail Prime Minister Boris Johnson's strategy and could trigger the opposition Labour Party to agree to a general election.
- Thailand: Hosts a meeting of Association of Southeast Asian Nations (ASEAN) economic ministers in Bankok, along with dialog partners from the US, China, Russia, and Japan. (through September 11)
- ★ US: Lawmakers return to Washington DC after a six-week summer break with a focus on spending legislation needed to keep the government open.
- 2:00am – Germany:
  - Trade Balance
  - Exports – Jul (Last: -0.1% m/m)
  - Imports – Jul (Last: 0.5% m/m)
- 4:00am – UK: Bank of England's Gertjan Vlieghe speaks.
- 4:30am – EU: Sentix Investor Confidence – Sep (Last: -13.7)
- 4:30am – UK:
  - Monthly GDP (3M/3M) – Jul (Last: 0.3%)
  - Industrial Production – Jul (Last: -0.1% m/m)
  - Industrial Production – Jul (Last: -0.6% y/y)
  - Manufacturing Production – Jul (Last: -0.2% m/m)
  - Manufacturing Production – Jul (Last: -1.4% y/y)
  - Trade Balance – Jul
- 11:30am – US: $45b 3M and $42b 6M Treasury Bill Auctions
- 3:00pm – US: Consumer Credit – Jul (Last: $14.596b)
- ★ 9:30pm – China:
  - CPI – Aug (Last: 2.8% y/y; Con: 2.6% y/y)
  - PPI – Aug (Last: -0.3% y/y; Con: -0.9% y/y)

Tuesday, September 10

- Germany: German Finance Minister Olaf Scholz presents spending plans to parliament. Chancellor Angela Merkel addresses the budget debate the next day.
- US: Bank of England Governor Mark Carney joins Robert Rubin to discuss monetary policy in New York.
- US: Apple launches its new iPhone.
- 1:30am – France:
  - Industrial Production – Jul (Last: -2.3% m/m)
  - Industrial Production – Jul (Last: 0.0% y/y)
  - Manufacturing Production – Jul (Last: -2.2% m/m)
  - Manufacturing Production – Jul (Last: -0.6% y/y)
- 4:00am – Italy:
  - Industrial Production – Jul (Last: -0.2% m/m)
  - Industrial Production – Jul (Last: -1.2% WDA y/y)
- ★ 4:30am – UK: Labor Market Report
- 6:00am – US: NFIB Small Business Optimism – Aug (Last: 104.7)
- 8:15am – Canada: Housing Starts – Aug (Last: 222.0k)
- 8:30am – Canada: Building Permits – Jul (Last: -3.7% m/m)
- 10:00am – US: JOLTS Job Openings – Jul (Last: 7348)
- ★ 1:00pm – US: $28b 1Y and $38b 3YTreasury Note Auctions

Wednesday, September 11

- 8:30am – US:
  - PPI Final Demand – Aug (Last: 0.2% m/m; Con: 0.0% m/m)
  - PPI Final Demand – Aug (Last: 1.7% y/y)
  - PPI Ex Food and Energy – Aug (Last: -0.1% m/m; Con: 0.2% m/m)
  - PPI Ex Food and Energy – Aug (Last: 2.1% y/y)
  - PPI Ex Food, Energy, and Trade – Aug (Last: -0.1% m/m; Con; 0.2% m/m)
  - PPI Ex Food, Energy, and Trade – Aug (Last: 1.7% y/y)
- 10:00am – US:
  - Wholesale Inventories – Jul F (Last: 0.2% m/m)
  - Wholesale Trade Sales – Jul (Last: -0.3% m/m)
- ★ 1:00pm – US: $24b 10Y Treasury Note Auction (Reopening)
- 7:50pm – Japan:
  - Core Machine Orders – Jul (Last: 13.9% m/m)
  - Core Machine Orders – Jul (Last: 12.5% y/y)
  - PPI – Aug (Last: 0.0% m/m)
  - PPI – Aug (Last: -0.6% y/y)

Thursday, September 12

- ★ Abu Dubai: OPEC+ meets on sidelines at World Energy Congress.
- ★ US: President Trump meets with the Emir of Kuwait, Sheikh Sabah Al-Ahmad Sabah at the White House.
- EMs: Turkey, Malaysia, Peru, and Serbia announce monetary policy decisions.

- 12:30am – Japan:
  - Industrial Production – Jul F (Last: 1.3% m/m)
  - Industrial Production – Jul F (Last: 0.7% y/y)
  - Capacity Utilization – Jul (Last: -2.6% m/m)
- 1:00am – Singapore: Retail Sales – Jul (Last: -8.9% y/y)
- 2:00am – Germany:
  - CPI – Aug F (Aug P: -0.2% m/m)
  - CPI – Aug F (Aug P: 1.4% y/y)
  - CPIH – Aug F (Last: -0.1% m/m)
  - CPIH – Aug F (Last: 1.0% y/y)
- 2:45am – France:
  - CPI – Aug F (Aug P: 0.5% m/m)
  - CPI – Aug F (Aug P: 1.1% y/y)
  - CPIH – Aug F (Aug P: 0.5% m/m)
  - CPIH – Aug F (Aug P: 1.2% y/y)
- 4:00am – Italy: Unemployment Rate – Q2 (Last: 10.4%)
- 4:30am – Hong Kong: Industrial Production – Q2 (Last: 1.4% y/y)
- 5:00am – EU:
  - Industrial Production – Jul (Last: -1.6% m/m)
  - Industrial Production – Jul (Last: -2.6% y/y)
- ★ 7:45am – EU: The ECB announces its policy decision on three key rates: deposit rate (-0.4%), main refinancing rate (0.0%), and marginal lending facility (0.25%). In addition, we expect them to announce a new net-asset purchasing program and changes to its rules limiting the amount of debt it can purchase of member countries.
- ★ 8:30am – EU: Mario Draghi speaks in Frankfurt at post-meeting press conference.
- ★ 8:30am- US:
  - CPI – Aug (Last: 0.3% m/m; Con: 0.1% m/m)
  - CPI – Aug (Last: 1.8% y/y; Con: 1.7% y/y)
  - Core CPI – Aug (Last: 0.3% m/m; Con: 0.2% m/m)
  - Core CPI – Aug (Last: 2.2% y/y; Con: 2.3% y/y)
  - Real Average Hourly Earnings – Aug (Last: 1.3% y/y)
- 8:30am – Canada: New Housing Price Index – Jul (Last: -0.1% m/m)
- ★ 1:00pm – US: $16b 30Y Treasury Bond Auction (Reopening)
- 2:00pm – US: Monthly Budget Statement – Aug (Last: -$119.7b)

Friday, September 13

- 5:00am – EU: Trade Balance – Jul (Last: €20.6b)
- ★ 8:30am – US:
  - Retail Sales Advance – Aug (Last: 0.7% m/m; Con: 0.3% m/m)
  - Retail Sales Ex Autos – Aug (Last: 1.0% m/m; Con: 0.2% m/m)
  - Retail Sales Ex Autos and Gas – Aug (Last: 0.9% m/m)
  - Retail Sales Control Group – Aug (Last: 1.0% m/m; Con: 0.4% m/m)

- Import Price Index – Aug (Last: 0.2% m/m; Con: -0.5% m/m)
- Import Price Index ex Petroleum – Aug (Last: 0.0% m/m)
- Import Price Index – Aug (Last: -1.8% y/y)
- Export Price Index – Aug (Last: 0.2% m/m)
- Export Price Index – Aug (Last: -0.9% y/y)

★ 10:00am – US:

- University of Michigan Consumer Sentiment – Sep P (Last: 89.8)
- Business Inventories – Jul (Last: 0.0% m/m; Con: 0.4%m/m)

– Rebecca Kooshak, Economic Analyst