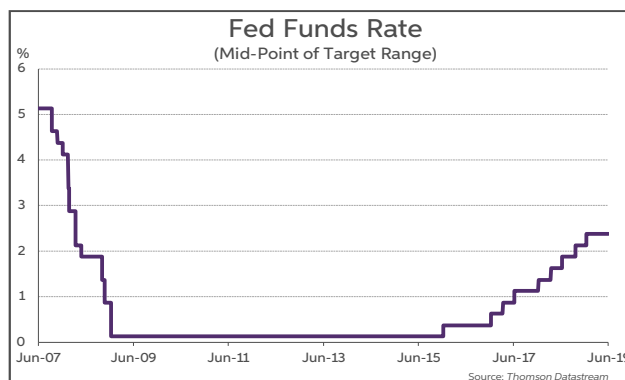


Fed opens door to rate cut(s)

As expected, the June meeting of the Federal Reserve Open Market Committee (FOMC) saw the target range for the key fed funds rate maintained at 2.25-2.50%. The decision to leave policy unchanged, though, was not unanimous, with one member (James Bullard) voting for a 25bps rate cut. The main focus for markets coming into the meeting was centred on what indications the Fed was going to provide regarding rate cuts.

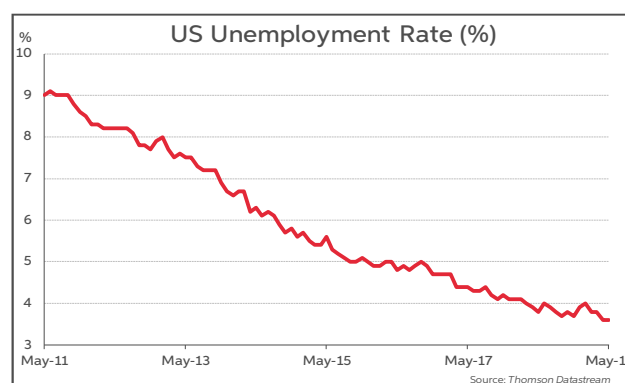
In this regard, the meeting statement showed that the Central Bank has turned more dovish. It removed the reference to being “patient” about changing policy and instead stated that it will “closely monitor incoming information” and will “act as appropriate to sustain the expansion”. However, at the same time, its characterisation of the economy remained largely positive in tone. The Fed referenced the fact that the labour market “remains strong”. Although it said the economy is now growing at a “moderate rate” compared to a “solid rate” previously. It also commented that measures of inflation expectations had declined and uncertainties about the outlook had increased. This was also reflected in the Fed’s new macro forecasts, with a slight downgrading of its inflation view for end 2019 (from 2.0% to 1.8%) and end 2020 (from 2.0% to 1.9%).



The updated interest rate guidance also showed a dovish shift from the Fed. While the median projection for end 2019 remained unchanged at 2.375%, 8 of the 17 FOMC participants are now expecting a rate cut by year end. It has changed its guidance for 2020, with the Fed replacing its previous 25bps rate hike with a 25bps rate cut. Meanwhile for 2021, the Fed is projecting a 25bps rate hike, with the fed funds rate back at 2.375% by end 2021. In short, the Fed guidance is no rate change this year, a rate cut next year, followed by a rate hike in 2021.

Fed Chair Powell commented in the press conference that even those participants who expected no changes to interest rates this year, agreed that the “case for additional accommodation” had strengthened since their May meeting. In this context, he referenced the “increased uncertainties”, re-emerging of crosscurrents (including global trade tensions), more risk averse markets and muted inflation pressures.

The market expectation is that the Fed will cut interest rate a number of times and soon. Futures contracts indicate the market has fully priced in a 25bps in July, followed by another cut in September and one in December. The market is also expecting a fourth rate cut by mid-2020, taking the fed funds rate down to 1.375%. So the market is expecting a much more aggressive pace of policy easing than the Fed is currently guiding.



The June FOMC meeting marks a dovish shift in the policy outlook for the Fed. However, the central bank has been careful not to box itself in regarding its policy outlook. The changes to its meeting statement shows flexibility on its part. This is because it remains uncertain as to whether rate cuts will be required given the still solid macro fundamentals in the economy. Although, it is also clear that the FOMC is split down the middle as to whether to leave rates unchanged or to cut them later this year.

Overall, it appears that the Fed is moving towards a pre-emptive rate cut for the US economy. However, for it to move to substantial rate cuts more in line with market expectations, it would require a significant deterioration in the economy and/or dislocation in financial markets, possibly linked to escalating global trade tensions. Following last night’s meeting, the dollar came under some downward pressure, with EUR/USD moving back up into the upper half of the \$1.12-1.13 band. Bond yields also fell further.

Signs growth is starting to slow in the US

US annualised growth accelerated to 3.1% in Q1, from 2.2% in Q4'2018. However, the growth rate was boosted by an outsized temporary contribution from net exports and changes in private inventories. In terms of domestic expenditure, consumer spending was relatively weak in the quarter, as was fixed investment, although government spending did pick up.

Survey data suggest that activity is likely to moderate in the second quarter of the year. The composite PMI dropped to a three year low of 50.9 in May. The underlying breakdown showed that both the manufacturing and the services sectors are struggling in the quarter. The manufacturing index fell to its lowest level in nearly 10 years, while the services index was at its lowest since February 2016. The May ISM reports suggested that the manufacturing was the main source of the weakness. The sector's index fell to 52.1, a 20-month low. Meanwhile the non-manufacturing ISM is below its 2018 averages but at 55.5, continues to point to solid growth.

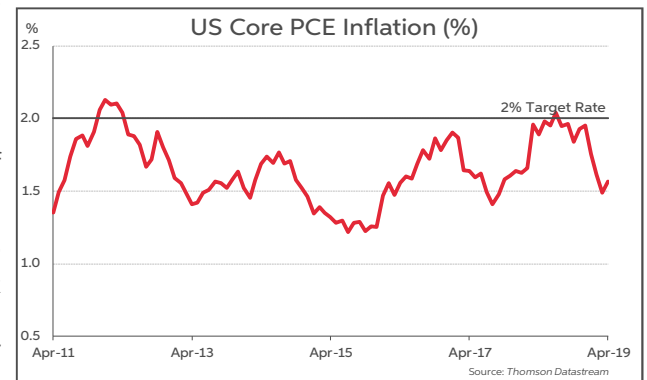
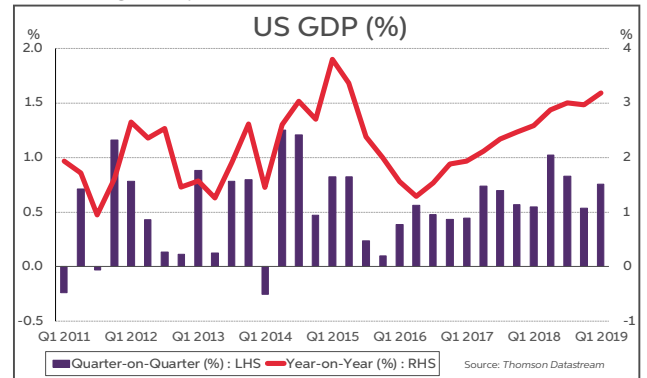
The available hard data for Q2 on the consumer side of the economy has been generally encouraging and suggest improvement compared to Q1. Retail sales registered solid monthly growth in both April (+0.3%) and May (+0.5%). At the same time, consumer confidence remains at elevated levels. Meanwhile, on the output side of the economy, the data have been more mixed. Headline industrial production registered its best monthly performance year to date, with a 0.4% growth rate in May after falling by the same rate in April. Growth in the manufacturing sector improved, albeit at a more modest pace (+0.2%). However, data from the housing market have been soft.

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Meantime, in terms of the labour market, there has been evidence in recent months that the rate of job growth is slowing. After a disappointing 75k reading from non-farm payrolls in May, the 3 month average now stands at 151k. This compares to six month of 175k and the 12 month average of 196k. A slowdown in the pace of employment gains is to be expected given how mature the current economic expansion is. The unemployment rate has held at a 50-year low of 3.6% in the quarter-to-date. The tight labour market conditions have helped the yearly growth rate of average earnings remain above 3%. **However, rising wages have not translated into higher inflation.** CPI edged lower in May (1.8% from 2.0%). Likewise, the Fed's preferred measure of inflation, core-PCE, stood at just 1.6% in April.

Growth in the US economy is expected to slow, but remain solid enough nonetheless. The boost from tax cuts at the beginning of last year is fading. However, a strong labour market should support the key consumer side of the economy (c. 70% GDP). Although, trade tensions between the US and its main trading partners are acting as a headwind. However, the Fed's willingness to "act as appropriate" to ensure that the US expansion continues, suggests that monetary policy should remain supportive of growth. **Today's forecast from the Fed is for US GDP growth to slow to 2.1% by end 2019.**

Over the medium term, there are risks facing the US economy. The US yield curve has recently inverted (10-year Treasuries below 3-month T-Bills) and such an inversion has preceded each US recession in the past 50-years. At the same time, the US expansion is now the longest on record, which therefore calls into question how much longer it can be sustained. Meanwhile, slower global economic growth as well as the aforementioned trade tensions are challenges facing the economy. The Fed sees the US economy slowing somewhat further, with GDP growing by 2% at end-2020 and 1.8% by end-2021.



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