No Need for Lower Rates, but Rate Cuts Likely Anyway

By Stephen Slifer *Thu, Jul 18, 2019*

'The Fed's story is confusing to us. Not only do we think lower rates are unnecessary, they are unlikely to help the Fed achieve its goals. Instead, Trump should focus on trade agreements around the world,' writes our guest columnist.

Many Fed officials are itching to cut rates. They keep saying that they see the potential for substantially slower GDP growth later this year. But with each passing data release there is no evidence that is happening or is on the verge of happening. It is true that inflation is running below the Fed's target and, while we expect it to climb almost to the 2.0% target level by yearend, the Fed could justify a rate cut by saying it wants to bring inflation back to or even slightly above, target quickly.

That would make sense, but to keep harping on some fear of future economic weakness seems implausible. If the economy were truly teetering on the brink of a significant slowdown, wouldn't stock market investors be getting a case of the jitters? They are not. The stock market is at a record high level.

Wouldn't small business owners be getting nervous? That is not happening either. Small business confidence has edged lower in the past six months, but it has backed off from a record high level in August of last year, which was the highest level of optimism since July 1983. Confidence remains at a lofty level.

Wouldn't we begin to see smaller employment gains as business people become more reluctant to hire? Monthly employment gains have shrunk from the 200+ thousand gains last year to about 180 thousand. But what did you expect? Employers simply cannot find enough qualified workers. Labor shortages are widespread. Most firms would love to see more qualified workers show up on their doorstep.

The only economic weakness we can find is in the manufacturing sector. The purchasing managers index has slipped considerably despite the fact that it is still consistent with 2.6% GDP growth. But the problem is not the level of interest rates. If rate levels were truly too high, wouldn't you expect to see both the manufacturing and service sectors showing signs of softening?

That is not happening. The manufacturing sector has weakened but the non-manufacturing sector has not. The non-manufacturing index remains at a relatively lofty level of 58.2 while service sector employment is robust and driving the economy.

We believe that manufacturing has been hit by the imposition of tariffs that began in the spring of last year and the ensuing trade war. Foreign investors quickly recognized that in the event of a trade war the U.S. would fare better than any other country because trade is such a small part of the U.S. economy. As the year progressed foreign funds poured into the U.S.

That boosted the level of the dollar, which meant that U.S. exports became more expensive for foreigners to purchase and, as a result, exports growth slowed. The solution is not to lower interest rates but, rather, reach trade agreements with China, the E.U., the U.K., Mexico and Canada. Once that happens the manufacturing sector will quickly heal.

The other piece that people focus on is the yield curve. With the funds rate at 2.38% and the 10-year at 2.12%, it is slightly inverted. While an inverted curve is typically a reliable indicator of an impending recession, it generally happens because the Fed has raised rates too quickly and Fed policy becomes “too tight.”

But with the funds rate today at 2.38% (by most estimates still below a “neutral” level), does anybody seriously believe that interest rates are too high and thereby impeding the pace of economic activity? Sorry, don’t buy it! The curve may be inverted, but for all the wrong reasons. Long rates have fallen below short rates, rather than short rates rising above long rates.

It is true that upon occasions in the past the Fed has cut rates to provide a little “insurance” in case something bad were to happen. But when it did so rate levels were much higher than they are today, and there was at least some hint that growth had begun to fade. The absence of any evidence that the pace of economic activity is slipping is what makes the Fed’s recent laser-like focus on lower interest rates so hard to comprehend.

It is true that the core personal consumption expenditures deflator is at 1.6% compared to the Fed’s 2.0% target. While we expect that rate to edge upwards as the year progresses and reach 1.9% by year-end, we could at least understand an argument by Fed officials that inflation has run below target for so long that it now wants it to climb above target for a while so that its average level for the cycle is 2.0%, and it needs lower rates now to make that happen quickly. That is, at least, a logical argument. This myth about slower growth ahead is not.

While we firmly believe lower rates are unnecessary, the reality is that Fed Chair Powell has done nothing to counter the widespread belief that it will cut rates at the end of this month. He certainly had ample opportunity when he presented his semi-annual report to Congress.

If the Fed does NOT lower rates at month end when such action is so widely anticipated, it can anticipate a sizable negative reaction in both the stock and bond markets. It does not want that to happen either. Thus, the best bet now is that the Fed will cut the funds rate by 0.25% at its July 30-31 meeting.

We have a hard time seeing how lower interest rates will boost the pace of economic activity. Clearly, lower rates will reduce the cost of corporate borrowing, which will, in turn, reduce costs and increase profits. Thus, the stock market will benefit. But even if firms have a desire to boost production, they will need more workers to make that happen and it will not be any easier to find qualified workers in the months ahead than it is today.

Thus, it is not clear to us that GDP growth will quicken in the quarters ahead even with lower interest rates. If the rate cuts stimulate demand, we could envision a slightly higher inflation rate as firms, perhaps, raise wages to attract additional workers, and then test the waters to see if they can get away with slightly higher prices.

But keep in mind that productivity gains thus far have countered all of the increase in wages so that unit labor costs are actually declining. Also, the Internet allows U.S. consumers to easily find the cheapest available price. That means that goods-producing firms will continue to have little pricing power and any increase in inflation is likely to be small.

Could lower rates actually make things worse? Probably not. Our biggest argument against a rate cut is that it provides the Fed with less ammo to use when the next downturn arrives—whenever that may be. While the end of the expansion has never been in sight for us, a rate cut—if it actually occurs—would push rates to levels that are even farther below a level that could bite and, therefore, extend the life of the expansion even farther.

The Fed’s story is confusing to us. Not only do we think lower rates are unnecessary, they are unlikely to help the Fed achieve its goals. Instead, Trump should focus on trade agreements around the world. Nonetheless, the Fed seems to have widely advertised its intention to lower rate. Let’s see what it does at the July 30-31 meeting and re-evaluate afterwards.