The July FOMC meeting delivered a rollercoaster ride in markets. Investors recalibrated for a statement that was broadly in line with expectations but at the margin slightly less dovish, reacted violently to remarks from chair Powell that the 25bp rate cut was a “mid-cycle adjustment” not the start of a lengthy cutting cycle, and then partially reversed after he clarified that he did not intend to signal one-and-done before sagging into the close.

On the substance, we think there was indeed a bit of deliberate fine-tuning of the message from the Fed today in the slightly less dovish direction but there was not a major shift in policy and not a break from the risk insurance paradigm. Mid-cycle adjustments in 1995-6 and 1998 involved a total of 75bp rate cuts in each case. A further cut in September remains the base case in our view though the Fed is signaling that it is not precommitting now to cut at that meeting.

We continue to believe the Fed will deliver at least one more cut before this mini-easing cycle is over and view Powell’s focus on global growth, trade uncertainty and muted inflation as fully consistent with this. And we still see a good likelihood that the world will evolve in a way that will require a third cut for a total of 75bp.

We consequently do not think a sustained sell-off in risky assets based on Fed signals would be warranted. But it is fair to say the message on the day was more in the direction of limited easing than aggressive easing – leaning two rather than two-plus cuts – and the impact of that fine-tuning was aggravated by the manner of its communication.

Let us elaborate on a few points:

1. **The FOMC delivered the expected 25bp rate cut but the market still had to price out residual speculation on a double-sized 50bp move.** Because of the asymmetric skew – almost no chance of zero, some chance of 50bp – the pricing out of 50bp delivered an initial repricing in the hawkish direction.

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**Market Movements, 31 July 2019, 2 - 3:37pm ET**

<table>
<thead>
<tr>
<th>Time</th>
<th>S&amp;P</th>
<th>Dollar (BBDXY)</th>
<th>10Y</th>
<th>2Y</th>
<th>10s2s</th>
<th>Fed Funds Jan 2020</th>
<th>Fed Funds Jan 2021</th>
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<td>2:00pm</td>
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<td>1.765</td>
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<tr>
<td></td>
<td>-0.23%</td>
<td>0.21%</td>
<td>-1.6bp</td>
<td>2.4bp</td>
<td>-4.0bp</td>
<td>4.5bp</td>
<td>-5.0bp</td>
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<td>Peak Powell</td>
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<td>-1.9bp</td>
<td>15.0bp</td>
<td>-10.7bp</td>
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<td>0.137</td>
<td>1.795</td>
<td>1.47</td>
</tr>
<tr>
<td></td>
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<td>0.53%</td>
<td>-0.4bp</td>
<td>7.6bp</td>
<td>-8.0bp</td>
<td>7.5bp</td>
<td>1.0bp</td>
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</table>
2. The statement overall was broadly unchanged, dovish and nods loosely in the direction of a September rate cut but a tweak from “closely monitor” to “continue to monitor” signals that a September cut is not precommitted. We view “closely monitor” as a very strong signal of imminent action and “continue to monitor” as a softer signal that dials back slightly the degree of forward-leaning activism. But we would not overdo this point. It is not unreasonable to dial back the language after delivering the first cut. The overall language remains dovish and activist: uncertainties about the outlook “remain”, the Committee will “continue to monitor” them and will “act as appropriate to sustain the expansion.” That does not feel like one and done. And while the new language would allow for a second cut to be delayed from September for instance to October we still view September as a good base case.

3. Two members – George and Rosengren – dissented as we expected but underlining that a significant part of the FOMC does not buy into the case for preemptive insurance cuts. We are confident that there remains a solid working majority of the FOMC in favor of the insurance paradigm which involves taking out insurance before the house is on fire. But Powell likely wishes to maintain as broad a coalition inside the FOMC and among the larger group of FOMC participants as possible, and this may have encouraged him to present the FOMC’s message in a way that maintains a broad church of internal support.

4. Powell presented three reasons for cutting rates: to insure against downside risks, to help offset the impact of trade uncertainty / slower global growth in the base case (in our language, short-run r* lower) and to support a faster return of inflation to target – adding at one point that lower estimates of the natural rate of unemployment and neutral rate of interest also contributed to the FOMC’s thinking. Somewhat ambitiously, he suggested that today’s 25bp cut would help address all of these three goals by moving policy to a modestly accommodative posture.

5. The Fed chair presented today’s move as the “continuation” of a larger adjustment in Fed rate plans since the start of the year in a manner that looked backwards rather than forwards for total cumulative easing. We thought this element was a bit hawkish. By emphasizing the cumulative adjustment in the Fed rate path since the start of the year Powell seemed to guide against assuming that a lot of additional easing would be necessary to effectively promote the three goals cited above – though it is also possible that he was trying more narrowly to address the argument that the Fed should have done a 50bp cut today.

6. Powell stumbled in trying to avoid saying too much about the forward path of policy while at the same time distinguishing between a “mid-cycle adjustment” and a lengthy series of rate cuts. Against the backdrop of the slightly less dovish / more hawkish tone above this was read as outright hawkish. As noted above, we did not read it that way – in both 1995-6 and 1998 mid-cycle adjustments totaled 75bp in each case. Late in the press conference Powell – perhaps alerted to the market sell-off – explicitly pointed to these prior examples and said “I did not say it was just this one or anything like that.”

7. The renewed invocation of data dependence in the context of the forward path of policy came across a bit hawkish but may not really be too hawkish if you take a
broad rather than narrow view of what the relevant information is. A literal read would certainly caution that data-dependence means further rate cuts are not outright guaranteed. But it is important to understand what the Fed is referring to when it says it is data dependent. The FOMC said it was data-dependent in June but cut in July even though the domestic activity, labor market and inflation data came in on net a bit better than expected. In our view this is because the key decision-makers on the FOMC are taking a much broader view of the relevant data and information than real time US macro data alone – spanning global growth, trade and other geopolitical uncertainty and trend inflation / inflation expectations.

8. A broad focus on global growth, trade uncertainty (expect Brexit uncertainty to join this list soon) and inflation (necessarily including indicators of inflation expectations) will keep the Fed oriented towards some further insurance cuts in our view. We think it was telling that when Powell was asked what type of information the Committee would be looking at when considering the future path of policy he repeatedly began by citing these factors, though he added domestic US economic data. We expect that in the coming months global growth will remain weak, trade uncertainty will remain very elevated, Brexit uncertainty will become globally macro-significant and indicators of inflation expectations will remain soft – and against this backdrop and ongoing related weakness in US manufacturing and investment the FOMC will cut again likely in September and (much less certainly) in December even though the US consumer-services-labor market complex should show continued resilience.

9. Balance sheet reduction will finish two months early consistent with our expectations while the FOMC left open the question of when it will allow natural growth in the balance sheet to resume. We continue to believe that the Committee will allow natural growth to resume sooner rather than later and think there is a fair chance this announcement could come in September, which would be mildly risk positive.
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