<u>Understanding The Federal Reserve Decision to Cut the Fed Funds Interest Rate on July 31</u>

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The Federal Reserve's Federal Open Market Committee ("FOMC") meets Tuesday and Wednesday to decide on whether to cut the Federal Funds interest rate and by how much. The consensus is for a cut of 0.25% to be announced on Wednesday, based on the odds reflected in the Fed Funds futures markets. To do otherwise would strike fear and create pandemonium in financial markets.

The Fed has three options for reducing the Fed Funds rate of interest:

<u>No Cut:</u> The economic "data" supports no reduction in the Fed Funds rate this month. Second quarter GDP growth first estimate announced last Friday was at 2.1% even after the inventory reduction drag and reduced spending by businesses on new buildings.

- Job growth remains strong and the economist consensus is for another 170,000 jobs to be added in July. Unemployment remains low and wages are rising. Inflation is slightly below the Fed's 2% target.

- Consumer and business confidence remain reasonably strong. Second quarter corporate earnings are coming in above expectations.

- Responsibility for stimulating China, Europe, UK, Japan and emerging market economies rests with their own central banks and fiscal authorities. Not surprisingly, these non-US central banks and other agencies are acting to stimulate their own economies.

- The recently silenced core of those who still support further rate increases believe it unwise to try to get ahead of the dangers of a slowing US economy before all the culprits are identified.

<u>0.25% Cut:</u> This is the odds-on favorite. It is what the markets are betting and where Fed decision-makers seems to have settled, though not until former Fed Chair Janet Yellen gave it her blessing.

- Not that a ¼ point reduction in the Fed Funds rate makes a material difference to borrowers, but it seems to have symbolic importance that the Fed doing something, lest it be blamed for inaction if the economy slows further.

- The economic impact of tariffs on Chinese goods and the uncertainty about further trade turmoil have damped economic activity around the world. The rate cut is viewed as proof that the Fed sees this and will do what is needed to prevent trade turmoil from killing off the economic growth cycle.

- The President's pressure on the Fed to cut – to give him more latitude in pressuring the Chinese, as the US trade delegation is back in China this week – has been effective. No amount of theoretical independence insulates the Fed Chair and Governors from White House and Congressional rhetoric.

<u>0.50% Cut</u>: Except from politicians, there isn't much support for a cut of this size.

- Although the first cut in a new cycle historically has been .5%, this easily could frighten financial markets about what the Fed knows but isn't saying.

- It also uses up precious room for future cuts when they may be needed most.

- Moreover, the supporters of lower rates would prefer to see an additional cut in September and again in December, rather than a larger cut now, that might only fizzle.

What Fed Chair Jerome Powell says in his press conference is as important – some say even more so. He has the opportunity to comment on future rate reductions, an earlier end to Fed balance sheet reductions and the FOMC's view on the importance of factors outside its traditional mandate of low unemployment and price stability.

With the stock markets having already priced in the 0.25% cut in the July run ups, the next market moves will be based on what the Fed Chairman signals it will have in mind for its next meetings. In the meantime, the daily rising and falling expectations for a substantive US-China trade deal will be principal market drivers.

Former Fed Chair Janet Yellen observes that continuing low inflation gives the Fed room for a .25% cut due to trade turmoil weakening of the global economy that ultimately affects US economic growth. China, Japan, UK and the Eurozone are struggling. She also points out that such a move doesn't need to be seen as the beginning of a "major easing cycle."

So the case for a 0.25% cut this week, to be followed by one or more additional ¼ point cuts as a measure of safety and insurance, is winning the day. Whether the announcement and press conference can convey this successfully is to be determined. Disparate political voices will make this a difficult job. The case for a substantial easing cycle, which this is not, would be data driven and depend on a series of disappointing new job months and a decline in consumer confidence.

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