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Fed Cuts, but Not Dovish Enough

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As expected, Fed policymakers cut the target federal funds range 25 basis points to 2.00 – 2.25 percent. Although their view for the U.S. economy remained favorable, weakening global growth, ongoing trade tensions and persistently low inflation caused the committee to lower its assessment of the appropriate policy rate to support domestic economic growth. As such, Fed policymakers cut rates for the first time since December 2008.

While market participants had fully priced in the rate cut, policymakers surprised participants by ending its balance sheet reduction program effective August 1, two months ahead of schedule. In May, the Federal Reserve announced its' plans to scale back the reinvestment of maturing U.S. Treasuries from $30 billion to $15 billion per month and, additionally, to continue to allow approximately $20 billion of mortgage-backed security (MBS) holdings to roll off its balance sheet per month as those securities mature. Today, the committee announced its' intentions to reinvest all maturing U.S. Treasuries and to reinvest up to $20 billion per month of principal payments from agency debt and MBS in Treasury securities. All principal payments over $20 billion will be reinvested in MBS. This policy change signals that Fed officials stand ready to use their balance sheet to implement monetary policy.

Key Points:

- **Mixed economic data prompted the rate cut.** Job growth remained strong through June, but the pace of wage growth has not put upward pressure on inflation. Household consumption remained strong in the first half of the year, but weakness in business investment and manufacturing sectors continued. The Fed's preferred measure of domestic inflation, core Personal Consumption Expenditures (PCE) increased 0.1 percent to 1.6 percent from May to June but remained stubbornly low. While news of the rate cut made headlines, changes to the Fed's balance sheet program also warrant considerable attention and may have implications on U.S. dollar strength.

- **U.S. equities moved sharply lower following the Fed announcement and ended the session down 1.1 percent.** Federal Reserve Chairman Powell tried to sell the rate cut announcement as a proactive decision by policymakers to support domestic economic growth against a backdrop of slowing global growth, but market participants did not buy it. Although investors priced a rate cut into the market ahead of today's announcement, Powell was not as dovish as anticipated, and investors responded by modestly lowering expectations for additional rate cuts this year.

- **The U.S. Treasury yield curve shifted roughly two basis points lower** (one- and three-month Treasury bills fell four basis points), but the front of the yield curve remained inverted and signals that market participants believe the Fed will need to cut rates at least once more in 2019. At the close of trading, the Federal Funds futures market priced in one more rate cut and a 40 percent chance for a third by year-end.

For more information and assistance, please contact any professional at DiMeo Schneider & Associates, L.L.C.

About the Author:

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Steve provides investment consulting services to institutional clients and nonprofit organizations. He services clients by providing advice and expertise on asset allocation, portfolio design, investment policy statements, manager search process, fiduciary stewardship, and overall investment management. Prior to joining the firm in 2017, Steve was an Associate Client Investment Officer with Northern Trust Asset Management where he provided comprehensive investment management services to discretionary institutional client portfolios. Steve earned a BA in Economics and Finance from the University of Illinois Urbana-Champaign and a Masters of Analytics from the University of Chicago. He is a CFA® Charterholder and a member of the CFA Institute, CFA Society of Chicago, and The Chicago Council on Global Affairs. Additionally, he serves on the investment committee of Special Kids Foundation, a nonprofit that makes a positive impact in the lives of children with developmental disabilities through education, treatment and/or inclusion. Steve enjoys outdoor activities and spending time with family.