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ECONOMIC REPORT

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FED FUNDS RATE CUT, AS EXPECTED, WITH END TO BALANCE SHEET REDUCTION; CONSUMERS SOLID IN JUNE

SUMMARY

- As expected, the FOMC cut the fed funds rate by 0.25 percentage point, citing downside risks to the outlook, particularly global developments. However, the FOMC was positive on current economic conditions.
- The FOMC also announced that it is ending the process of reducing the central bank's balance sheet.
- PNC expects another 0.25 percentage point rate cut in October.
- Consumer incomes and spending both rose moderately in June. Consumers are in good shape in mid-2019.
- Inflation remains below the Fed's 2 percent objective.

As expected, the Federal Open Market Committee announced on July 31 that it is cutting the fed funds rate by 0.25 percentage point, to a range of 2.00 to 2.25 percent. The FOMC cited downside risks, particularly "the implications of global developments for the economic outlook," as the primary reason for the rate cut: "This action supports the Committee's view that sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective are the most likely outcomes, but uncertainties about this outlook remain."

This was the first rate cut since late 2008, when the FOMC pushed the fed funds rate close to zero in an effort to combat the Great Recession. The FOMC had slowly but steadily raised the fed funds rate starting in late 2015, to a range of 2.25 to 2.50 percent by late last year.

The FOMC also announced that it is ending the process of reducing the size of the Fed's balance sheet on August 1, two months earlier than originally announced. This is likely because the FOMC did not want to be sending mixed messages, by cutting the fed funds rate (looser monetary policy) at the same time it was reducing the balance sheet (tighter monetary policy). The Fed undertook a huge increase in its balance sheet in the wake of the Great Recession, a process known as "quantitative easing" or "large-scale asset purchases." The central bank created money electronically and used the funds to purchase long-term assets, such as long-term Treasuries and mortgage-backed securities. The goal was to push down long-term interest rates, to encourage borrowing and support the recovery from the Great Recession. The Fed's balance sheet went from less than a trillion dollars in mid-2008 to $4.5 trillion in late 2014. The Fed started to gradually reduce the size of its balance sheet in early 2018 as the expansion continued; it is now at about $3.8 trillion (see Chart 1).

Although the Fed cut rates, the statement was positive on current economic conditions, citing moderate economic growth, solid job gains, and good consumer spending. However, the statement did note soft business fixed investment. The statement also noted that inflation remains below the FOMC's 2 percent objective.

The statement did not give an indication of the FOMC's next move, saying that the committee "will continue to monitor the implications of incoming information for the economic outlook and will act as appropriate to sustain the expansion, with a strong labor market and inflation near its symmetric 2 percent objective." Despite this lack of guidance, PNC expects the FOMC's next move to be another 25 basis point rate cut, likely in October. The committee will hold off at its next meeting, on September 17 and 18, waiting to see how growth and inflation respond to the rate cut, and how risks evolve. However, risks to growth are likely to remain weighted to the downside, supporting another rate cut on October 30. PNC expects the FOMC to then hold the fed funds rate in a range of 1.75 to 2.00 percent throughout 2020.

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Two FOMC members (Kansas City Fed President George and Boston Fed President Rosengren) voted against the action, preferring to keep the funds rate unchanged.

In his press conference after the release of the statement Fed Chair Powell was positive on the economic outlook, saying that the economy was in good shape, with little threat from the domestic sector. Instead, he said that “downside risks are really coming from abroad.” He called this rate cut a “mid-cycle adjustment,” and said that it was “not the beginning of a long series of rate cuts.” But Powell did indicate that the FOMC could cut the fed funds rate again in the near term if conditions warranted.

The immediate market reaction was negative; markets were expecting a firmer commitment to additional rate cuts from Powell. The S&P 500 was down about 1 percent between the release of the statement and the market close, although at one point it was down almost 2 percent. The yield curve remained inverted, with the 10-year Treasury yield down to 2.02 percent following Powell’s press conference, and the 3-month Treasury yield up a bit to 2.07 percent. The U.S. dollar, measured against a basket of currencies, strengthened and hit a two-year high, while the price of a barrel of West Texas Intermediate crude oil fell to around $58.

Personal income increased 0.4 percent in June before inflation, as did after-tax (disposable) income. Consumers’ income is steadily rising thanks to good job gains and solid wage growth; labor market income was up 0.5 percent in June. Consumer spending rose 0.3 percent in June before inflation, after bigger gains in March through May. As incomes rise, households are increasing their spending commensurately.

Inflation remains a non-issue. The personal consumption expenditures price index (the Fed’s preferred inflation measure) rose 0.1 percent in June, with the core PCE price index, excluding volatile food and energy prices, up 0.2 percent for a third straight month. On a year-ago basis overall PCE inflation was 1.4 percent in June. Core inflation was 1.6 percent in June, up from 1.5 percent in March through May; it has been consistently below the Federal Reserve’s 2 percent objective throughout the current expansion.

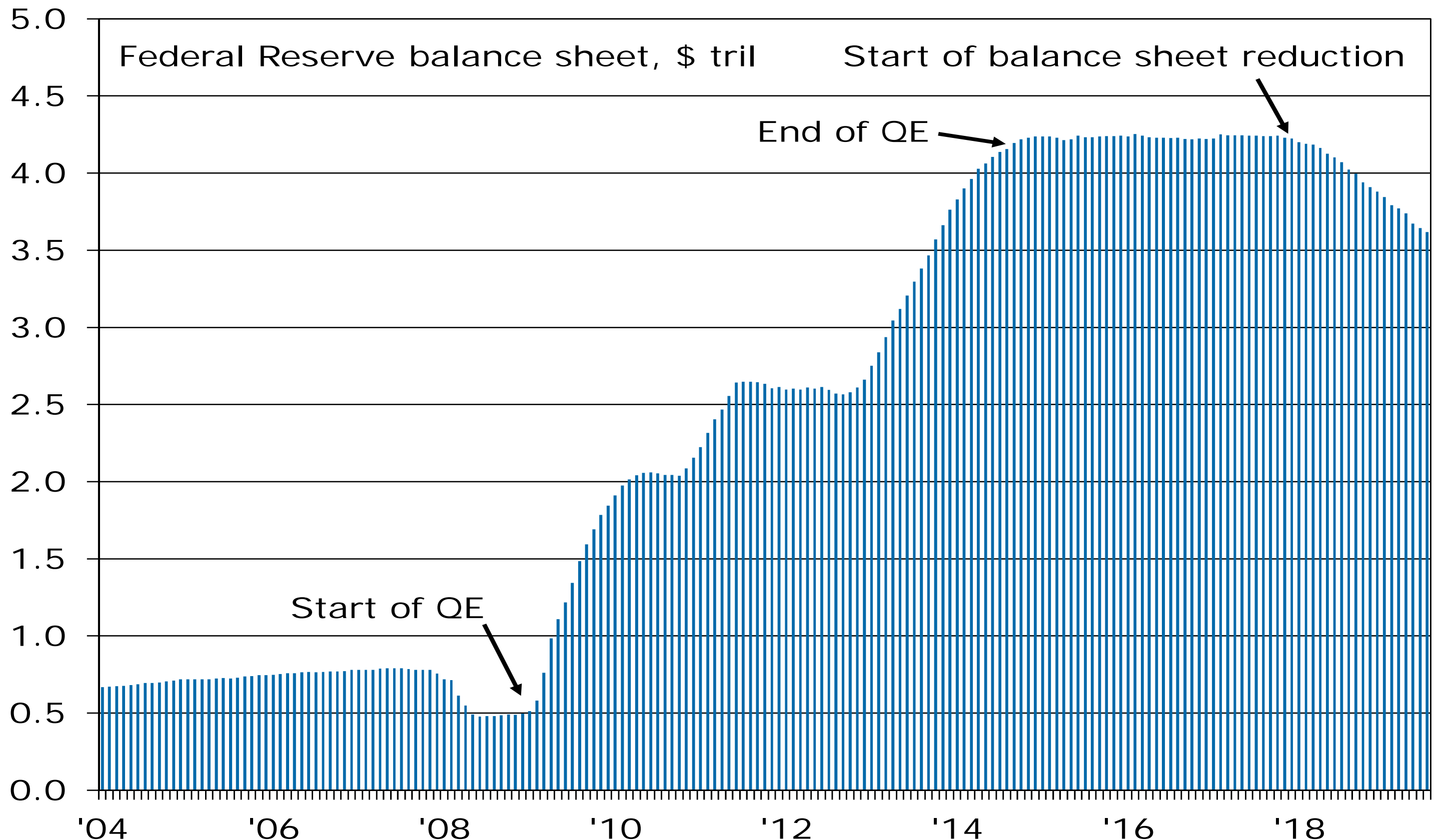

Chart source: Federal Reserve Board

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After adjusting for inflation, after-tax income was up 0.3 percent in June, with spending up 0.2 percent. On a year-ago basis inflation-adjusted after-tax income was up 3.3 percent, while inflation-adjusted spending was up 2.5 percent.

With incomes up more than spending in June, the personal saving rate rose to 8.1 percent in June, from 8.0 percent in May.

There was an upward revision to after-tax income in 2017 of 0.2 percent, and larger upward revision in 2018 of 1.4 percent. Consumer spending in 2018 was revised up by 0.3 percent. With the big upward revision to disposable income in 2018, and a smaller upward revision to consumer spending, the saving rate for 2018 was revised up 1.0 percentage point to 7.7 percent. It appears that households saved most of their personal income tax cuts last year.

Consumers are in good shape in 2019, and that means the current expansion, already the longest in U.S. history, will continue. Incomes are rising steadily thanks to the strong labor market, and households are appropriately increasing their spending, without getting overextended. Consumer outlays account for more than two-thirds of U.S. GDP, and continued gains in consumer spending will allow the current expansion to last at least through the rest of 2019 and into 2020; recent recession concerns are overblown. The big upward revision to the saving rate is reassuring; households are prepared should economic growth slow (see Chart 2). In contrast, the saving rate was below 4 percent in 2006 and 2007, heading into the Great Recession; consumers cut back sharply on spending once the recession hit, exacerbating the downturn.

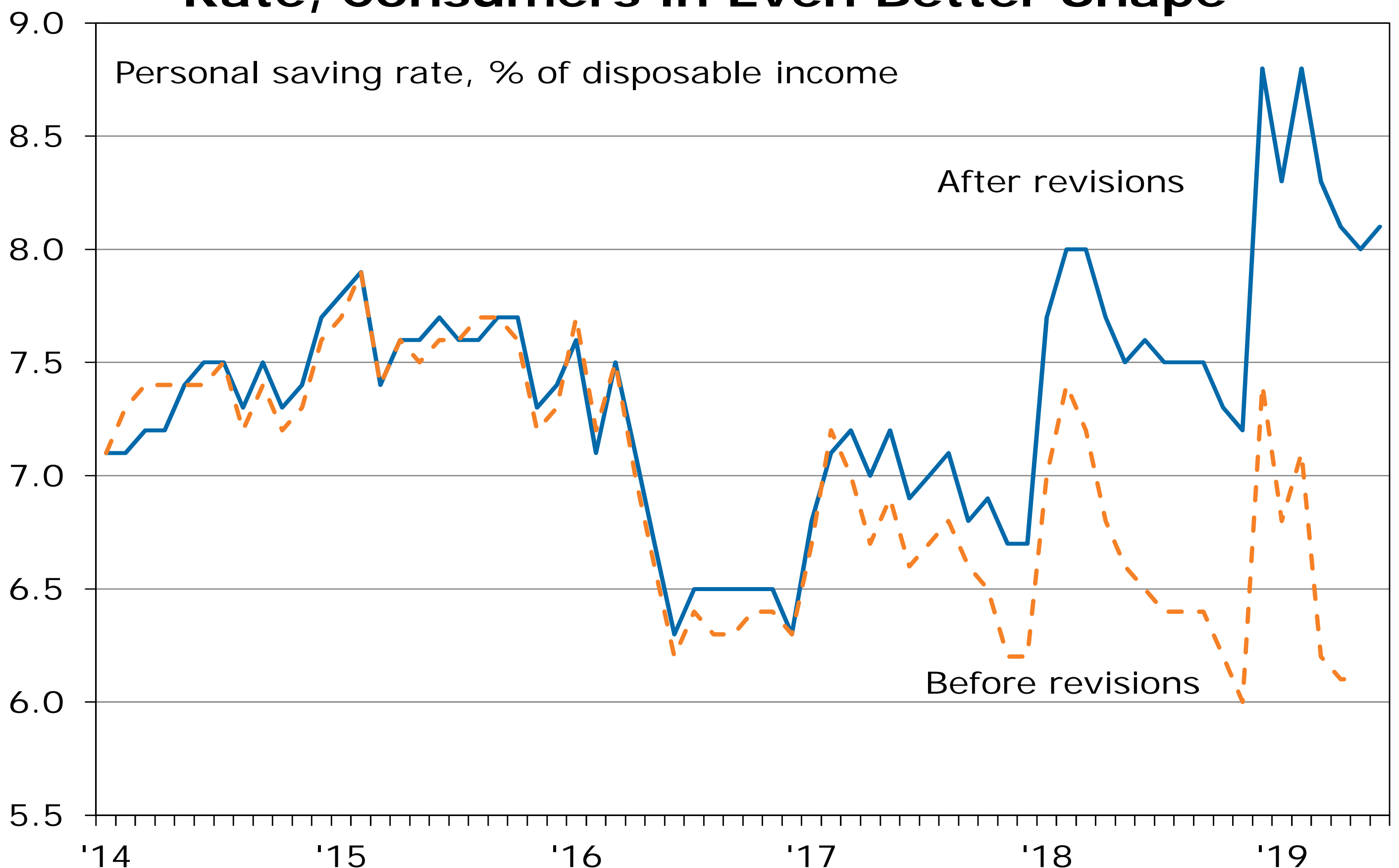

Chart source: Bureau of Economic Analysis

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