Will the Fed lose its patience this week?

June 17, 2019 | Kristina Hooper, Chief Global Market Strategist

All eyes will be on this week's US Federal Reserve (Fed) meeting – especially the statement (whether the central bank will retain its "patient" stance) and the "dot plot" (which charts the outlook for interest rates). The June 18-19 Fed meeting is very important because market expectations have gotten so dovish recently. And with risks rising, many investors recognize that once again the Fed stands between them and a more challenging stock market environment.

Expectations are high for a rate cut this year

Many observers have become increasingly certain that the Fed will cut rates this year. After all, other central banks have already begun to cut rates this year – some in response to weakening economic conditions, some arguably in anticipation of a Fed move. Consider:

- India, Malaysia, and the Philippines have all cut rates since April.
- European Central Bank (ECB) President Mario Draghi recently suggested it was possible that the ECB could cut rates soon.
- The Bank of Russia cut its key interest rate by a quarter percentage point last week, citing the recent change in stance by the Federal Reserve. This central bank also suggested that it could cut rates further this year.

But will the Fed cut rates? Some may argue it is hard to justify given that US economic data has been relatively strong. However, it also appears that there are areas of weakness in the US economy – and that they mirror areas of weakness in other parts of the world. For example, last week saw some similarities between US and Chinese data: Both showed a rebound in retail sales in May but witnessed further weakness in the manufacturing sector. It appears that the global manufacturing sector has suffered, and tariffs – both directly and indirectly – seem at least partly to blame.

A worsening trade war could justify a rate cut

This situation could get worse as the globe has seen a continued rise in tariffs. In the last several days, India announced it would be applying tariffs to 28 products imported from the United States. This move was in response to the US' decision to terminate preferential trading partner status to India. And so while tariff wars are not good or easy to win, they do proliferate rather rapidly, like germs in a petri dish. If the situation worsens (and it could, given that US President Donald Trump has threatened to levy more tariffs on China if President Xi Jinping does not meet with him to negotiate at next week's G20 meeting), then the Fed could certainly help justify a rate cut based on concerns about burgeoning tariff wars and their impact on manufacturing and the overall economy.

However, I must stress there doesn't need to be any deterioration in economic data or any rise in tariffs to trigger a Fed rate cut. As I have mentioned before, the Fed could just raise its inflation target, which it has hinted at possibly doing. This would enable it to justify a cut in rates without any change in economic data.

What to watch for at the Fed meeting

In my view, investors don't need to get a rate cut at the June meeting, but I think they will want the door opened to the possibility of a rate cut this summer. I believe markets are expecting to at least see the removal of the "patient" language from the Fed statement, although they would clearly welcome a downward revision to the dot plot.

Over the past week, I have repeatedly been asked what would happen if the Fed doesn't meet market expectations for dovishness. If markets don't see a strong willingness by the Fed to move toward more accommodation, I would expect them to register their disappointment in a stock sell-off. I think such a sell-off could be significant given the magnitude of the drop in policy expectations over the past several weeks, but I also believe it could be relatively short-term in nature. After all, the Fed will have four more opportunities this year to meet – or at least move closer to – market expectations.

However, I must stress that I believe that question is moot. I expect we will see at least some move toward more dovishness this week – i.e., the removal of the "patient" language – and that that should be enough to satisfy investors. And because the Fed has been holding press conferences after every announcement, Fed Chair Jay Powell will have the opportunity to soothe markets even if they are not sufficiently satisfied with, for example, the new dot plot. I believe the Fed needs to establish its willingness to cut rates in the coming months, but it will also strive to retain its flexibility. It doesn't want to appear to commit to a rate cut, as conditions could change; for example, it would not want to feel compelled to cut rates this summer if the economy suddenly appeared to be overheating (although that seems unlikely given subdued inflation readings recently). In addition, I would argue too much dovishness in one announcement might actually frighten markets.

Other events to watch this week

We will also want to focus on some other events in the coming week:

- In the UK, the next Tory leadership election is on June 18, and there will be further votes among Members of Parliament during the week. So, by the end of the week, we should know which two finalists will be put before the party membership for final selection. A Johnson versus Raab contest would likely be worst from a market point of view, as it would increase the risk of a no-deal Brexit. Johnson versus Gove, Johnson versus Javid, or Johnson versus Hunt would offer a bit more hope that a Brexit deal could be arrived at – but not much as the Conservative members appear smitten with the idea of Boris Johnson as the next Prime Minister.
- This is a big central bank week beyond just the Fed:
  - Brazil's central bank meets on June 19; no cut is expected, but the economy is weak so there is a possibility of a cut.
  - The Bank of England meets on June 20, but no change is expected. Some policymakers are talking about rate hikes, but I don't expect any hike; in fact, cuts may be needed if Brexit goes badly.
  - The Bank of Japan meets on June 21. No rate change is expected but it appears interested in finding other forms of stimulus.
- This week, flash Purchasing Managers' Indexes (PMIs) for June will be released for the US, the eurozone, Japan and Australia. PMIs are an important leading indicator, so we will want to follow them closely to get a sense of the current state of some of the biggest economies in the world.

Important information

Blog header image: Hendrik Morkel/Unsplash.com

The Federal Reserve's "dot plot" is a chart that the central bank uses to illustrate its outlook for the path of interest rates.

Brexit refers to the scheduled exit of the UK from the European Union. In a "no-deal" Brexit, the UK would leave the EU with no formal agreement outlining the terms of their relationship.

Purchasing Managers' Indexes are based on monthly surveys of companies worldwide, and gauge business conditions within the manufacturing and services sectors.

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