First rate cut since 2008, but not start of a trend

July 31, 2019

Key points:

- The U.S. Federal Reserve cut its key interest rate by a quarter point as expected but did not signal further easing.
- Trade uncertainty remains a threat; growth fears deepen

For the first time since the Great Recession, the Federal Reserve cut interest rates by 25 basis points (bps). However, Fed Chairman Jerome Powell characterized the move as a "mid-cycle adjustment," signaling that this may not be the start of a new period of easing. Powell cited uncertainties over U.S.-China trade, soft global economic data and low inflation as factors in the Fed's decision.

Markets initially reacted poorly to the Fed's messaging. Here are key takeaways from some of our affiliate investment teams:

Eagle Asset Management:

"The Fed is historically always late to the party. Hiking last December they failed to recognize the risks to the economy and the slowdown in U.S. growth that was already underway," said James Camp, CFA, Managing Director of Strategic and Fixed Income at Eagle Asset Management. "Now the Fed waited several months before cutting all the while the yield curve was indicating that monetary policy was too tight."

The Fed has a communication challenge, in Camp's view. "Will the market believe the Fed is cutting rates in order to sustain the expansion or cutting because they're behind again? Based on the initial market reaction post-cut, it appears as the latter."

"The yield curve is still telling you monetary policy is too tight, particularly when you look at sovereign rates around the world," says Camp. "Although one cut will have a limited effect on the overall economy, there's a psychological, self-fulfilling component to the Fed's actions and messaging."

Camp believes that looser financial conditions should be a positive to investors, but mounting risks should not be dismissed.

Absolute levels of economic data remain supportive of modest growth; however, the trends are not reassuring, particularly in manufacturing, so risks remain elevated in the near-term.

Scout Investments:

The rate cut could help equities trade higher in the second half of the year, according to the Scout Investments Mid Cap Equity team. However, Scout portfolio managers are concerned that the Fed cut by only 25 bps, as opposed to what they viewed as a more prudent 50 bps cut. Powell appearing to put the brakes on further cuts only deepens this concern.

"The risk of the Fed staying 'behind the curve' remains, similar to their track record in the last two bear markets," the Mid Cap team said.

Looking ahead:

The Eagle Fixed Income team believes there will likely be one more quarter-point rate cut this year. At the same time, recent gains in wages may limit the Fed's urgency for additional cuts. The Scout Mid Cap team continues to monitor downside risk, and believes the Fed's current course appears overly optimistic.

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