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Goldilocks and the Insurance Rate Cut

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The Fed just lowered interest rates by 25 basis points—is this a good or bad sign for the economy? The goal of the Fed is to keep the U.S. economy growing at just the right pace, not too hot and not too cold. The economy appears to be pretty close to just right if one looks at headline GDP numbers. However, there are cracks beneath the surface of the economy and there are headwinds from the global economy that put the expansion at risk of going cold. By lowering rates for the first time in 10 years the Fed is trying to give the economy some additional strength to extend the expansion—now the longest in history—and lessen any downturn caused by slowing global growth or shocks to the economy.

What caused the Fed to be concerned about the U.S. economy?
Investment has been weak. Business investment, which helps drive growth and innovation, has been weak so far in 2019 rising by only 1.9% in the first half of the year compared with 6.4% in 2018. Surveys suggest that business leaders—the ones who make future investment decisions—believe the probability of a recession is elevated. The June 2019 Duke University/CFO survey showed 69% expecting a recession by the end of 2020, up from 67% expecting a recession by Q3 2020. Separately, the July 2019 Conference Board CEO Confidence survey found that 44% of those surveyed expect economic conditions to worsen in the next six months, up from 42% last quarter. This suggests that business investment is unlikely to rebound unless something changes. Like interest rates.

Another crack is the real estate market, which is highly sensitive to interest rates. As rates rose housing activity contracted. However, the change in the Fed's stance starting in January of 2019 helped bring down mortgage rates. The 30-year fixed mortgage rate has dropped nearly one full percentage point to under 4% this year from 4.8% last November[1]. Although residential investment fell by 1.5% in Q2 on an annualized basis, the year-over-year measure has turned upward in the last few quarters. Further, mortgage loan applications have risen as rates fell in line with the change in the Fed's stance from hiking, to pausing, to cutting. This rate cut could give an additional assist to housing.

Finally, inflation—one of the Fed's main targets—has been consistently below 2.0% during the long expansion[2]. Lower interest rates bring down borrowing costs, which spurs economic activity. However, the expectation that greater economic activity will help spur inflation remains an open question and could possibly back the Fed into a corner if inflation does not accelerate over the next year.

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[1] Bankrate.com, July 31, 2019

[2] Bureau of Economic Analysis, July 30, 2019

What are the international risks?
Economic growth is slowing around the world. Several large economies, such as South Korea, Brazil, Mexico, Italy and Germany, are in or on the verge of recession. Indeed, South Korea cut interest rates recently and the European Central Bank has telegraphed that a rate cut is on the way. Additionally, the slowdown in global manufacturing that started in China and has reverberated around the world is not moderating as much as anticipated. Finally there are a host of risks associated with shifting trade regimes—most notably a possible hard Brexit and ongoing U.S. tariff negotiations.

Does everyone agree?
No. Eric Rosengren, President of the Boston Fed, and Esther George, President of the Kansas City Fed, both dissented[3]. That is, they voted to keep interest rates where they were as they believe economic activity had not slowed to the point of signaling an imminent recession. It is unusual for more than one Federal Open Market Committee (FOMC) member to dissent, suggesting that risks associated with lower rates are also a consideration for the Fed.

The equity market also appeared to be initially disappointed with this rate move. Financial markets were in fact hoping not only for a larger rate cut, but also for language in the FOMC statement indicating a series of rate cuts would be forthcoming. No doubt the presence of two dissenting votes constrained Fed Chair Jerome Powell's remarks that the cut was a "mid-cycle adjustment to policy" rather than "the beginning of a long series of rate cuts," which clearly influenced the market's reaction. Nevertheless, Chair Powell was clear that should "global crosscurrents" intensify, the Fed stands ready to act by lowering rates further to stem a negative economic shock.

Has the Fed ever done this before?
Yes, twice. In 1995 the Fed lowered rates after an aggressive bout of rate increases. This was in the wake of the 1995 Mexican debt crisis and a slowing global economy and manufacturing sector. In 1998, the expansion had been going on for seven years and a string of global events from the Asian financial crisis to the Russian debt default had weakened the global economy—again seen mostly in manufacturing.[4] These parallels to today's situation suggest that sufficient rate cuts can help stabilize interest rate sensitive sectors in the middle or later stages of a business cycle, thus prolonging the expansion.

What is the timing of a recession if the Fed successfully prolongs the expansion?
Recession timing has been pushed forward by Fed action. In the best case, the Fed saw the writing on the wall and is able to prolong the expansion. In the worst case, we learn that the Fed has neither the power nor the ammunition at this point to ward off what proves to be an inevitable recession. The key to determining which scenario prevails depends largely on the type of recession the U.S. economy experiences.

Recessions come in many varieties, but they can be narrowed down to two key types. The first is a business-cycle recession, in which shortages push up prices, constraining the ability of businesses to expand at the pace they wish and eventually inducing the central bank to raise rates to cool the economy. While it may appear the Fed causes a recession, most economists believe the Fed's action dampens the magnitude of both the expansion at the end of the business cycle and the recession at the trough.

The second type of recession is caused by an external, or as economists would say, exogenous, shock, such as the weakness coming from international economies. There is the risk that a series of insurance rate cuts are insufficient to turn around the global economy. Should the

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[3] FOMC Statement, July 31, 2019

[4] https://www.federalreserve.gov/pubs/ifdp/2000/669/ifdp669.pdf

global economy weaken further, this could slow U.S. growth to the point of causing a mild recession due to insufficient demand.

The more worrisome type of shock would be a global financial shock or debt deleveraging. This would cause contagion via financial markets as well as economic channels and would require more nimble liquidity provisions be put in place before the shock occurred. The single largest current global worry stems from China; the persistent trade war adds salt to an already wounded Chinese economy that is heavily indebted. Added to this are the ongoing tensions in Hong Kong, where the banking system is five times the size of its economy and a policy misstep could have global repercussions. In addition, bank deposits also dwarf FX reserves and a loss of confidence could cause contagion and put pressure on global liquidity[5].

Ultimately, we do not believe the business cycle is dead. Therefore, if the Fed successfully creates Goldilocks conditions and prolongs the expansion, businesses would do well to plan for the day when the expansion comes to an end. While that day is now possibly pushed into 2020 or beyond, this late stage expansion does present business challenges as well. An extended expansion will mean tighter labor markets, input price pressures and increased competition. Businesses that remain proactive and agile, investing in productivity-enhancing tools and strategies, will come out ahead.

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[5] Sources: International Monetary Fund, June 30, 2019; Bank of International Settlements; World Bank, August 2, 2019