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The Case for 50

The Fed is going to cut interest rates on September 18. The only question is by how much. Chair Powell will speak on the economic outlook at the annual Jackson Hole Economic Policy Symposium this Friday at 10 am EDT. He will leave his options open with respect to the size of the first interest rate cut.

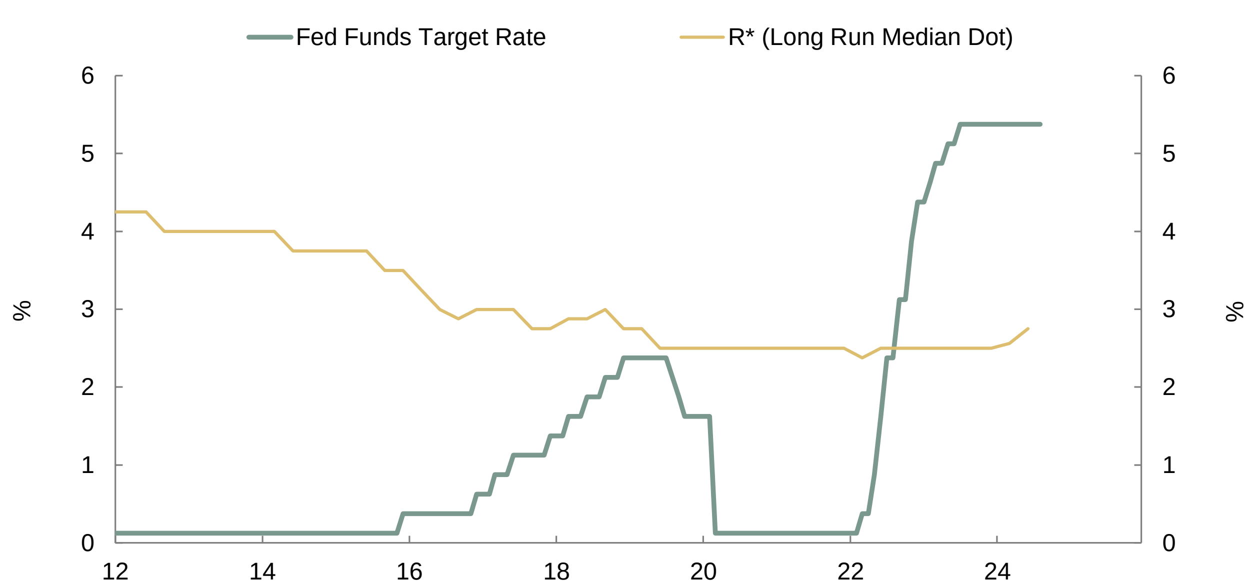
The results of the August employment report will be central to the near-term outlook. Another soft NFP reading — after just a 114k gain in July — and yet another increase in the unemployment rate from 4.3% would almost guarantee a 50 basis point (bp) rate cut. But there is another reason for the Fed to cut by half of a point.

The current Fed funds target rate is 5.375%, the midpoint of its 5.25% to 5.5% range. According to the June FOMC interest rate projections, the longer run central tendency or what is also referred to as the neutral rate, natural rate of interest or R-Star is between 2.5% to 3.5% on fed funds. New Fed forecasts are released next month.

The current "central tendency" excludes the three lowest and three highest forecasts of the neutral rate. However, the "range" of estimates include all policymakers and is from 2.4% to 3.8%. By all accounts, **the current funds rate is much too high relative to neutral,** as illustrated in the chart below. Therefore, the funds rate needs to come down.

From a risk management approach, it would be more prudent for the Fed to go big than to go small. **A 50 bp September cut would still leave the funds rate about 100 bps above the highest estimate of the natural rate**. A 25 bp fine tuning is not enough. Why go incrementally if inflation is trending lower and there is concern that the labor market may be on the cusp of a more meaningful slowdown? If monetary policymakers are confident that they will be cutting again, a larger initial rate cut give them more optionality. How so?

If the economy turns out to be stronger than expected, the Fed can refrain from a November 5 rate cut. But if growth appears to be downshifting more quickly, and the Fed needs to cut again, a large September rate cut will look prudent. Remember the Fed eased 50 bps to begin their 2001 to 2002 and 2007 to 2009 rate cutting cycles. A famous Alan Greenspan quote may be appropriate: "An economy looks really good in a freefall until it hits the ground." We eagerly await Chair Powell's speech and the results of the August jobs report.



Source: Federal Reserve, Haver, SMBC Nikko

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