LPL RESEARCH

WEEKLY ECONOMIC COMMENTARY

June 17, 2019

SETTING THE STAGE

John Lynch *Chief Investment Strategist, LPL Financial*
Barry Gilbert, PhD, CFA *Asset Allocation Strategist, LPL Financial*
Callie Cox, *Senior Analyst, LPL Financial*

KEY TAKEAWAYS

The Federal Reserve is scheduled to announce its next policy decision June 19.

We think a language change is more likely than a policy change at this meeting.

Economic fundamentals are still sound, but the Fed must address plans to mitigate trade risk.

These next two weeks are pivotal for the global economy. The Federal Reserve's (Fed) next policy meeting starts June 18 with a policy announcement due June 19. In the following week, global leaders will convene at the G-20 Summit in Japan, and we'll likely get clues on the state of the U.S.-China trade talks.

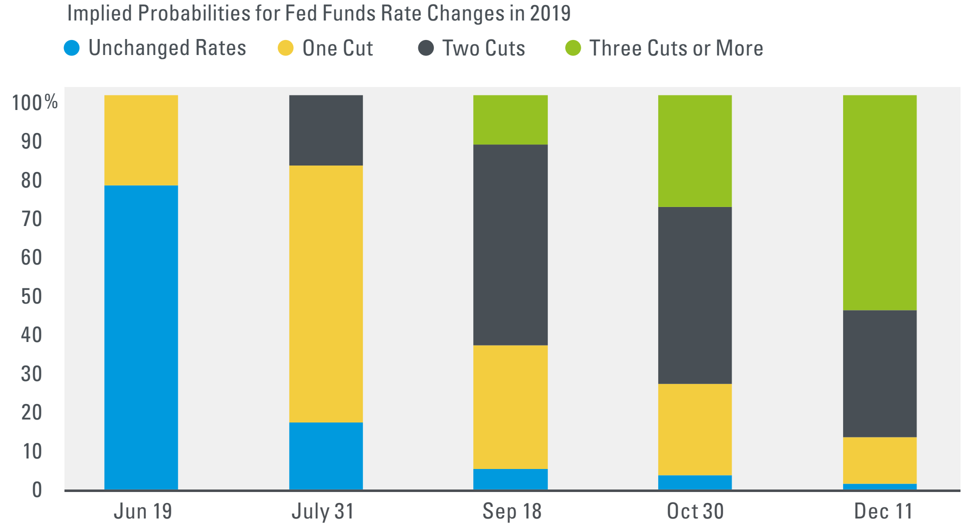
Fed fund futures are pricing in about a 20% chance of a rate cut at the upcoming meeting [Figure 1]. We think a rate cut could be in play later this year if global conditions deteriorate, but a policy change at this next meeting may be too soon. Regardless, Fed commentary on the state of the economy and policy has been critical for markets lately, and we expect policymakers to address their plans to mitigate risks of a trade-related slowdown.

SLOWING INFLATION

Last week's inflation data reflected the trade dispute's growing strain on the U.S. economy. Year-over-year growth in the core Consumer Price Index (excluding food and energy prices) slowed to a 14-month low. Core Producer Price Index

1 FED FUND FUTURES EXPECT FIRST CUT IN JULY

Implied Probabilities for Fed Funds Rate Changes in 2019



The economic forecasts may not develop as predicted.

Source: LPL Research, Bloomberg, Federal Reserve 06/12/19

A rate cut is a 25 basis point (0.25%) reduction from the current upper bound fed funds rate of 2.5%.

LPL Financial

growth fell to a 16-month low, and wage growth declined to a nine-month low. Most importantly, core personal consumption expenditures (PCE),the Fed's preferred inflation gauge, sits about 40 basis points (0.40%) below policymakers' 2% target. The recent slowdown has been discouraging, even though inflation gauges haven't fallen to alarming levels. We're starting to see employer pricing pressures weaken though, a sign that catalysts for higher inflation could be fading.

Tepid inflation alone may be enough cover for the Fed to cut rates this year. However, it's tough to gauge how much a rate cut could help stoke pricing pressures. Consumer inflation has been dragged down by acyclical goods, such as consumer goods and services, according to Fed Bank of San Francisco data. Pricing pressures from acyclical goods can't be easily influenced by policy, as acyclical inflation doesn't necessarily correlate with economic activity or the business cycle. Logically, lower rates should boost demand in more cyclical parts of the economy, such as housing. Economic data are still sound on balance, but there are more signs that growth could slow if the U.S.-China trade dispute drags on. The bond market is also signaling that policy may be too tight for prolonged trade uncertainty. It's a tricky environment, and the Fed may decide that cutting rates now may not justify the potential consequences.

LANGUAGE SHIFT

Still, it's become painfully obvious that the Fed needs to address its plan to combat a potential slowdown from trade risk. At this point, we think the Fed will likely tweak its "patient" language in preparation for eventually adjusting policy if conditions continue to deteriorate. We've seen a similar measured approach from the Fed when making policy changes over the last several years, and it's largely worked well. In the past month, policymakers have started to publicly acknowledge the possibility of a rate cut, and investors have reacted well to the Fed's flexible language. The most telling example was Fed Chair Jerome Powell's June 4 comment that policymakers "will act as appropriate to sustain the expansion," which powered the S&P 500 Index to its best day since January. A language change could also reassure investors while buying the Fed more time to watch for G-20 developments and monitor incoming data. Of course, we don't think the Fed should bow to markets in its policy decisions, but preparation is needed for a smooth transition.

The Fed will also release an updated dot plot, or summary of policymakers' rate projections, as well as new economic and inflation projections. That information alone will be immensely helpful in preparing investors for a shift. Powell's comments at the post-meeting press conference also will be useful in understanding the Fed's thought process around these new projections and less quantifiable variables, like trade uncertainty. Unfortunately, that means investors could hang on every word Powell says, leading to more turbulence for the stock market.

At any rate, investors should view a rate cut as a course correction and not as a decision to get ahead of an imminent recession. Right now, we see fundamentals that increasingly point to slowing growth instead of a downturn. Historically, the Fed has had to adjust its rate path within an expansion when global events, the economy, or markets signal rates are too high for the current environment. Policy is at its tightest point of the cycle, but the Fed is mindful of trade-related consequences and willing to be flexible to keep growth stable.

CONCLUSION

We're considering the Fed's June meeting as policymakers' chance to set the stage for future policy adjustment. The Fed may strike a more cautious tone in its commentary this week than its "patient" policy theme from the past few months.

As with any Fed meeting, we'll be watching for any developments or changes in projections or language. If there are changes, we encourage investors to view them in the context of a solid macroeconomic environment but with increasing risk from trade uncertainty. ■

MIDYEAR OUTLOOK 2019

LPL Research *Midyear Outlook 2019* containing our updated insights on the economy and markets for the second half of 2019 will be released June 24. As a result, we will not distribute a separate *Weekly Market Commentary* or *Weekly Economic Commentary* that Monday. We will resume distribution of the stand-alone commentaries Monday, July 1.