

Tim Duy's *Fed Watch*

JUNE 5, 2019

Fed Prepared to Adjust Policy As Needed

Recent Data

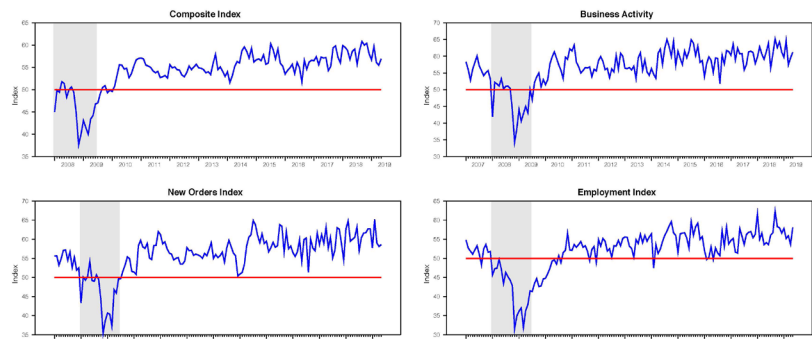
Incoming data has been...well, not terrible really despite the pessimism bubbling over on Wall Street. The ISM manufacturing report was on the soft side, to be sure, but still nothing like the kind of weakness typically associated with recession.

The ISM nonmanufacturing report, however, held strong in May. At least for now, it looks like the two indexes are diverging much as they did in 2015-16. This potential divergence is of course important, very important. **The services sector is a much bigger portion of the economy. We need to be careful about not extrapolating a manufacturing sector specific shock to the rest of the economy.** Are tariffs an economy-wide shock or primarily a manufacturing shock? How much would they bleed into the broader economy? It's something we need to keep in mind after the false recession signal sent by manufacturing data in the 2015-16 period.

Note also the ISM manufacturing employment component remains in positive territory whereas in 2015-16 it dipped below 50. Moreover, the service sector employment component jumped higher in May. Both are inconsistent with the disappointingly small 27k gain in the ADP employment numbers. Also inconsistent are the initial unemployment claims numbers, which are pretty much flat this year and not jumping higher as might be expected in the event of a material change in the labor market. **More on the labor market below.**

ISM Non-Manufacturing Indexes

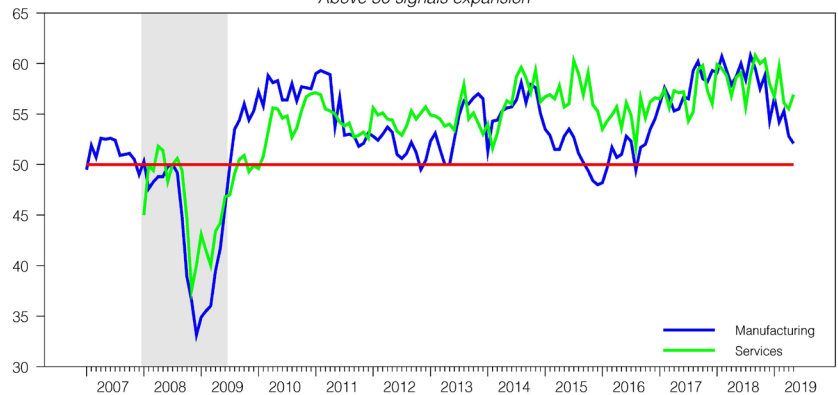
Above 50 Indicates Expansion



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ISM Composite Indexes

Above 50 signals expansion



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The Federal Reserve released a fresh Beige Book ahead of the upcoming FOMC meeting. Interestingly, as of mid-May the anecdotal evidence indicated economic activity “expanded at a modest pace...a slight improvement over the previous period.” Also, growth was universal: Almost all Districts reported some growth, and a few saw moderate gains in activity. **Manufacturing, however, showed some cracks in the foundation:**

Manufacturing reports were generally positive, but some Districts noted signs of slowing activity and a more uncertain outlook among contacts.

That uncertainty has certainly risen given that the trade dispute with China remains unsettled while President Trump escalated trade uncertainty with his threat of tariffs on Mexico.

Fed Speak

The highlight of the week were the comments by Federal Reserve Chair Jerome Powell. He added a paragraph to his speech Tuesday to signal that the Fed will "act as appropriate to sustain the expansion." For more on Powell, [see what I wrote earlier this week](#).

Powell's colleague Lael Brainard backed him up in an interview with Yahoo! Finance, reassuring market participants that the Fed would adjust policy accordingly. In regards to what she is looking at:

LAEL BRAINARD: So I think I look very carefully at the payrolls number that comes out at the end of this month (sic). I don't tend to take too much signal from one particular data point. I like to put it in context and look over several months and look at that trend line.

But I will be paying very close attention to the payrolls number on Friday. And the labor market does give us a lot of signals about what's going on in the economy. Initial claims is another important one that I pay a lot of attention to.

The key here is that the Fed continues to look at the totality of the data, not just any one data point, and then adds in the risks to the outlook, such as trade wars, so assess the appropriate policy path. Not one thing alone will prompt the Fed to alter interest rates.

At least one Fed official is ready for a rate cut. Earlier this week St. Louis Federal Reserve President James Bullard made his thoughts clear. Via Bloomberg:

"A downward policy rate adjustment may be warranted soon to help re-center inflation and inflation expectations at target and also to provide some insurance in case of a sharper-than-expected slowdown," Bullard said Monday in remarks prepared for a talk in Chicago. "The direct effects of trade restrictions on the U.S. economy are relatively small, but the effects through global financial markets may be larger."

Note that Bullard centers his case on the inflation outlook; his colleagues generally favor the view that the recent weakness is only transitory.

Upcoming Data

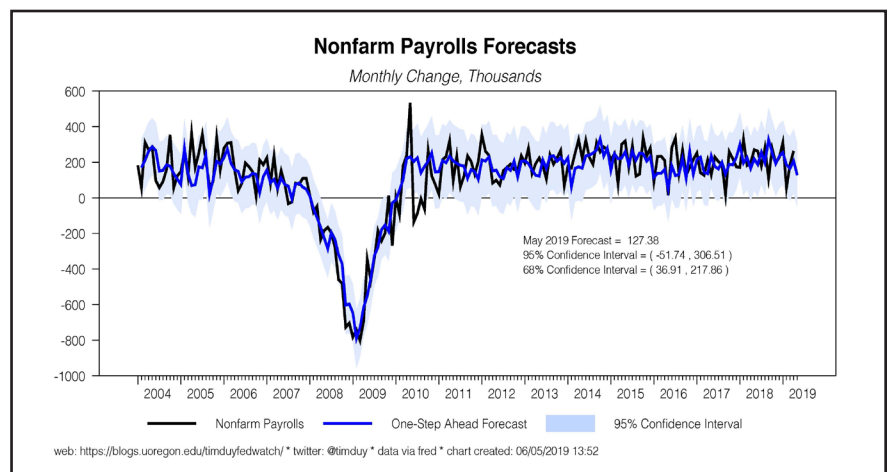
The highlight of the week is Friday Employment Situation report for May. The ADP report threw some cold water on expectations for the report. Still, Wall Street currently anticipates a gain of 180k compared to 263k in April. Incorporating the ADP numbers into my estimate yields a gain of 127k.

I fear that the ADP report may be a head fake given its inconsistency with other data as noted above; my experience is that when ADP misleads market participants, it misleads in a big way. That said, even if ADP does prove accurate and the employment report is on the soft side, the Fed will probably not take an excessively weak number seriously and instead see it as an outlier. **I think a modestly solid number like 125k would make more of an impact as it would be consistent with an expected slowdown in hiring that would help stabilize the unemployment rate. Still, as Brainard noted above, it is just one number.**

Discussion

Market participants continue to look for a rate cut. That's the story from the yield curve, and that story has only gotten stronger in recent weeks:

The 10s2s portion of the curve has yet to invert; I interpret this to mean that market participants believe policy is a bit too tight and if the Fed cut interest rates in the near future they can avoid a recession. I would be more worried about recession if the 10s2s inverted and the Fed was still hiking rates. I will become more worried if the Fed ignores the signal to cut from shorter end of the curve. **Truth be told, my own ongoing expansion forecast is very much dependent on the Fed cutting rates before recession-**



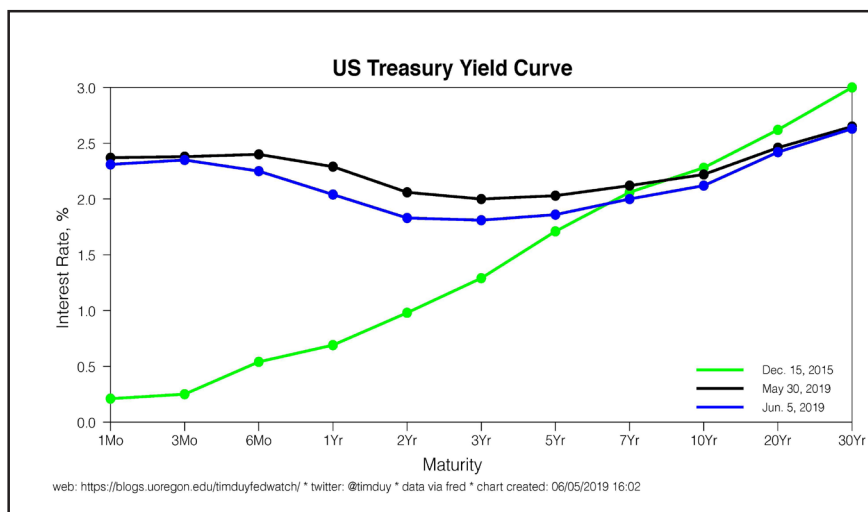
ary dynamics set in.

Luckily, as noted above, the Fed is increasingly open to the proposition that a rate cut might be necessary, even an insurance cut if the data continues to slow as expected and trade tensions boost the downside risks. I am challenged to see this cut come before September.

My read of the Fed is that the consensus FOMC view feels the expected slowing of activity remains inconsistent with a rate cut given the expectation that inflation rebounds while unemployment remains low. They don't want to get caught scurrying to hike rates again in a few months if risks suddenly dissipate. Hence, I think they need some additional confirmation from the data that a rate cut is necessary before cutting rates. **The exact timing is thus subject to evolving economic conditions, but if the economy slows as expected, I expect the Fed to have enough data in hand by September to make their move.**

Bottom Line: The missing piece in the rate cut story is seemingly the most important – a consistent pattern of data soft enough

to make the Fed fear there is a threat to the employment and inflation outlooks. I anticipate the data will soften enough in the next few months to prompt the Fed to act in September. How much softer? Given the rising risks to the outlook, the Fed seems to have set a fairly low bar for a rate cut. That means the data flow doesn't have to be too much softer.



TIMOTHY A. DUY
PROFESSOR OF PRACTICE
OREGON ECONOMIC FORUM, SENIOR DIRECTOR
DEPARTMENT OF ECONOMICS
UNIVERSITY OF OREGON

Professor Duy received his B.A. in Economics in 1991 from the University of Puget Sound, and his M.S. and Ph.D. in Economics in 1998 from the University of Oregon. Following graduate school, Tim worked in Washington, D.C. for the United States Department of Treasury as an economist in the International Affairs division and later with the G7 Group, a political and economic consultancy for clients in the financial industry. In the latter position, he was responsible for monitoring the activities of the Federal Reserve and currency markets. Tim returned to the University of Oregon in 2002. He is the Senior Director of the Oregon Economic Forum and the author of the University of Oregon Statewide Economic Indicators, Regional Economic Indicators, and the Central Oregon Business Index.

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Tim has published in the *Journal of Economics and Business* and is currently a member of the Oregon Governor's Council of Economic Advisors and the State Debt Policy Advisory Commission. Tim is a prominent commentator on the Federal Reserve. MarketWatch describes his blog as "influential." The Huffington Post identified him as one of the top 26 economists to follow on Twitter, and he is listed on StreetEye as one of the top 100 people to follow to discover finance news on Twitter. Major national and international news outlets frequently quote him, including the *New York Times*, the *Washington Post*, the *Financial Times*, the *Wall Street Journal*, and *Bloomberg*. He also writes a regular column for *Bloomberg Prophets*.

Notice: This newsletter is commentary, not investment advice.

✉ duy@uoregon.edu

☎ 541-346-4660

🐦 @TimDuy

