Trade Uncertainty Continues to Weigh on the Fed

The Federal Reserve lowered the overnight interest rate once again last week. It was the second quarter-point reduction in this easing cycle, following the first in late July. Highlighting the divergence of opinion regarding the outlook for the economy, there were three dissenting votes. One was cast by a participant who preferred a half-point rate cut, and two who preferred no cut at all.

In its post-meeting statement, the FOMC (Federal Open Market Committee) pointed to strong domestic labor markets and strong household spending. Conversely, it also pointed to weak business investment and export activity, and muted inflationary pressures. And although it did not specifically call out the higher level of U.S. trade policy uncertainty, the statement did reference, “the implications of global developments for the economic outlook,” in deciding to once again lower the overnight rate. However, in his opening remarks at the post-meeting press conference, Chairman Powell made specific mention of the trade war as a major source of the weakness in business investment and export activity cited in the meeting statement, saying in part, “…business investment and exports have weakened amid falling manufacturing output. The main reasons appear to be slower growth abroad and trade policy developments – two sources of uncertainty that we have been monitoring all year.”

In his remarks at the Jackson Hole Federal Reserve conference one month ago, Powell expressed the challenge faced by central banks in responding to trade headwinds, saying, “We have much experience addressing typical macroeconomic developments…But fitting trade policy uncertainty into this framework is a new challenge…There are…no recent precedents to guide any policy response to the current situation.”

Fed research quantifies the economic impact of trade policy uncertainty

The staff in the Division of International Finance at the Fed has this month published a research paper entitled, “The Economic Effects of Trade Policy Uncertainty.”* In it, the authors construct a series of models to quantify the economic impact of an increase in trade policy uncertainty of the magnitude experienced in the U.S. in 2018. It begins with the construction of several measures of trade policy uncertainty, based on newspaper mentions, corporate earnings call transcripts and U.S. historical experience of changes in trade policy. In the first part of the paper, the authors attempt to quantify the firm and industry level impact on capital investment, by observing changes in balance sheet values of capital assets, concluding that investment declined by roughly 1 percent in 2018, or the equivalent of roughly $25 billion. Of course, the impact varies depending upon the degree of exposure to export activity.
The second part of the paper examines the channels through which rising uncertainty impacts both capital investment and overall economic activity. The authors conclude that, “A rise in trade tensions leads to a sizeable decline in consumption, investment, GDP and consumer price inflation.” It finds that both the news and uncertainty of future higher tariffs reduces investment and output, but that the news about future higher tariffs accounts for approximately two-thirds of the effect, “…as it directly entails expectations for higher costs of imports and lower demand for exports. Higher uncertainty about tariffs also dampens investment and GDP by reducing firm entry into the export market and by triggering upward pricing bias for firms subject to pricing rigidity, which increases markups and reduces hours worked and output.” Under this methodology, the impact on capital investment is even higher, at roughly 1.5 percent. The initial annual impact on overall GDP is estimated to be roughly 0.75 percent.

Trade issues will play a significant role in the Fed’s next decision

Fed funds futures now anticipate a third quarter-point rate cut in December with a roughly 70 percent probability. Trade policy uncertainty will play a significant role in determining how the Fed responds. Recent talks between the U.S. and China have been characterized by both sides as productive, and further talks are expected to take place in early October. There are other outstanding trade issues as well, including talks this week with Japan which are expected to yield an agreement. But issues also remain with the EU (European Union) and the new trade agreement with Canada and Mexico (called USMCA) has yet to be ratified. Given the economic importance of clarity on trade policy as estimated by the Fed’s economic staff in its recent paper, it is no surprise that capital markets remain sensitive to any developments on the trade front. And no surprise that the Fed remains sensitive as well.


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