Why the Fed is in a No-Win Situation

The latest round of U.S. tariffs on Chinese imports took effect on Sunday as scheduled. There was no last-minute change of heart by the administration, as some had hoped. The tariffs amount to 15 percent on roughly $110 billion of mostly consumer goods and are in addition to the previously levied 25 percent tariff on approximately $250 billion of mostly intermediate goods, which levy is scheduled to rise to 30 percent in October. On Dec. 15, another approximately $150 billion of mostly consumer goods imports are scheduled to be tarifed at the 15 percent level. Additional tariffs on U.S. exports to China also took effect on Sunday.

Just where the trade war goes from here remains uncertain. Both sides say that talks are continuing and that a face-to-face meeting is expected to take place in September, although it has yet to be scheduled. In the meantime, the standoff continues to take its toll. Business investment in the U.S. remains under pressure as evidenced by the revised estimate of second quarter GDP, and manufacturing in China contracted for the fourth straight month in August, although the flash PMI showed a modest expansion for the month. Europe also continues to weaken, especially Germany, which may be headed to recession. Strength in the U.S. consumer sector remains the one bright spot, as already strong personal consumption in the second quarter was revised upward, and recent measures of consumer confidence have also held firm.

The trade war continues to expose policy differences in Washington. In his remarks two weeks ago at the Fed symposium in Jackson Hole, chairman Powell discussed the policy challenges posed by the trade war, especially at a time when the real neutral rate is so low.

“We (the FOMC) have much experience in addressing typical macroeconomic developments... But fitting trade policy uncertainty into this framework is a new challenge... In principle, anything that affects the outlook for employment and inflation could also affect the appropriate stance of monetary policy, and that could include uncertainty about trade policy. There are, however, no recent precedents to guide any policy response to the current situation. Moreover, while monetary policy is a powerful tool that works to support consumer spending, business investment, and public confidence, it cannot provide a settled rulebook for international trade. We can, however, try to look through what may be passing events, focus on how trade developments are affecting the outlook, and adjust policy to promote our objectives.”

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“Whether the Fed follows through with further rate cuts, as markets expect, remains to be seen. But regardless of how policy evolves, and the challenges that it faces, it will be difficult for the Fed to avoid further criticism, either for easing too slowly or too much.”
And in an extraordinary opinion piece published last week on Bloomberg entitled, “The Fed Shouldn’t Encourage Trump’s Trade War,” former New York Fed president and FOMC vice-chair William Dudley, now in the private sector, said:

“(Fed) officials could state explicitly that the central bank won’t bail out an administration that keeps making bad choices on trade policy, making it abundantly clear that Trump will own the consequences of his actions...There’s even an argument that the election itself falls within the Fed’s purview. After all, Trump’s re-election arguably presents a threat to the U.S. and global economy, to the Fed’s independence and its ability to achieve its employment and inflation objectives. If the goal of monetary policy is to achieve the best long-term economic outcome, then Fed officials should consider how their decisions will affect the political outcome in 2020.”

Not surprisingly, those views were met with considerable pushback, including from the Fed itself, which said political considerations play no role in its deliberations. And also not surprisingly, president Trump remained unpersuaded. Dismissing any suggestion that tariffs are hurting the economy, the president continued to harangue the Fed in a Twitter post last Friday saying “We don’t have a tariff problem...We have a Fed problem. They don’t have a clue.”

The Fed meets again later this month on the 17th and 18th. According to the CME FedWatch tool, there is a 97 percent probability of another quarter point rate cut, and 80 percent odds that another cut will follow by December. The yield on the ten-year Treasury note ended August at 1.50 percent. Before the Fed cut the overnight rate by one quarter percent on July 31 the yield was 2.06 percent. The yield curve between the three-month Treasury bill and ten-year note, which first turned negative back in March, was inverted by two basis points prior to the July cut and is now inverted by 49 basis points (a basis point is 1/100th of a percent). And the two to ten-year curve, which was 21 basis points positive back in July, is now inverted by 1 basis point, after turning negative two weeks ago.

Whether the Fed follows through with further rate cuts, as markets expect, remains to be seen. But regardless of how policy evolves, and the challenges that it faces, it will be difficult for the Fed to avoid further criticism, either for easing too slowly or too much.

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