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WEEKLY ECONOMIC COMMENTARY

July 15, 2019

CENTRAL BANK CHECK-IN

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KEY TAKEAWAYS

Recent Fed commentary reinforces the chance of a July rate cut.

Trade tensions and political pressures are forcing global central banks to loosen monetary policy.

Easing policy may provide a short-term boost, but the global economy needs trade resolution.

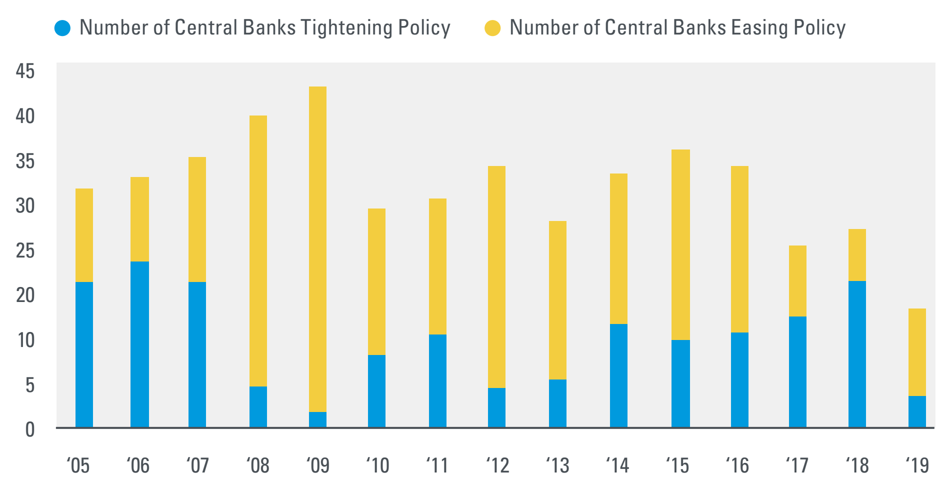
Financial markets are focused on U.S. monetary policy, but the Federal Reserve (Fed) is only part of the story. Central banks around the world are embarking on a marked policy shift as trade tensions pressure the global economy and government becomes more intertwined with policy decisions. Global monetary policy is still historically loose, but policymakers abroad are searching for alternatives to jump-start growth, with no trade resolution in sight [Figure 1].

FED POISED TO CUT

The Fed's policy shifts this year have been the most watched, as the U.S. central bank dictates monetary policy for the world's largest economy and most important financial centers.

It is no secret that the Fed is prepared to cut rates later this month, a move that was heavily implied when language about being "patient," intending to show the Fed wasn't in a rush to continue to hike rates, was removed from the Fed's June meeting statement. With further hikes no longer really on the table and cuts under discussion, the Fed reframed its messaging. Minutes from the Fed's June meeting showed "several" policymakers argued a cut could be "appropriate

1 GLOBAL CENTRAL BANKS BACK IN EASING MODE



Source: LPL Research, Strategas Research Partners 07/11/19

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policy from a risk management perspective" to cushion the economy against shocks from trade tensions and slowing global growth. Discussion about the U.S. economy in the minutes was largely optimistic, but Fed members frequently mentioned uncertainties and downside risks. Fed Chair Jerome Powell's testimonies to Congress echoed that sentiment. Powell repeated the Fed's view of a solid U.S. economy, but maintained that uncertainty from crosscurrents, accompanied by muted inflation, have continued to weigh on the domestic outlook.

We don't see an argument for a rate cut in recent economic data, and we agree with Powell's assessment of an economy in "good shape." However, the bond market has indicated that U.S. monetary policy is too tight for the uncertain trade environment. The Fed committed to patience and flexibility at the beginning of this year, but global economic conditions continue to deteriorate, and the still-inverted yield curve (short-term rates higher than long-term) has effectively tied policymakers' hands. More importantly, an "insurance" cut could provide a buffer if uncertainty continues to weigh on growth, reducing the chances of a policy mistake or a rush to cut rates before a recession.

ECB EXPLORES MORE EASING

Few central bankers have fought as tough of a battle over the past several years as those at the European Central Bank (ECB). ECB policymakers have attempted to spark growth and inflation with large-scale asset purchases, but structural issues, austerity measures, and political upheavals have largely overwhelmed benefits from looser policy. Now, global trade tensions and the threat of auto tariffs have put another dent in Europe's sputtering economy, and the ECB has few options available with its policy rate still at zero.

At the ECB's June meeting, policymakers pledged to hold rates at current levels at least through mid-2020 and used the phrase "as long as necessary" to convey flexibility to do more as needed. What "more" would be has yet to be determined, but there is speculation that the ECB could reinstate quantitative easing or consider negative rates.

To make matters more complicated, ECB President Mario Draghi completes his term at the end of October. Christine LaGarde, former managing director of the International Monetary Fund, was chosen to take Draghi's spot as head of the ECB. Even though LaGarde is well qualified, the change will come with new leadership and communication strategies. Even if largely consistent, there will be an adjustment period for global markets, with pivotal policy decisions looming. The ECB has all but promised more accommodation, and LaGarde will likely be tasked with introducing new policy measures early in her tenure. We have observed a pattern of markets testing new Fed chairs, and we would not be surprised to see a similar pattern in Europe.

To be clear, these are transitional pains the ECB likely would have faced no matter who was nominated to lead. Still, Draghi's retirement complicates the ECB's increasingly challenging situation at hand.

POLITICAL PRESSURES

Elsewhere, central banks are dealing with political pressures fueled by economic stress. In June, a governor at India's central bank quit unexpectedly amid Prime Minister Narendra Modi's ongoing pressure for looser policy, the second governor departure in the last seven months. A few weeks later, President Recep Erdogan fired the head of Turkey's central bank and demanded policymakers provide "stronger support for our economic program." Other regions are tackling different problems than the U.S. Fed, but many central banks have faced the same challenge of maintaining independence in a politically charged environment. Ultimately, we think increasing political heat internationally could lead to more dramatic policy decisions and encourage other governments to follow suit.

CONCLUSION

The Fed is poised to cut rates in July, as Powell's comments and June meeting minutes reinforced last week. If that happens, we encourage investors to view the rate adjustment as a course correction and not as an attempt to get in front of an impending recession.

Central banks globally are fighting more uphill battles, though, and events this summer show the economic stress has led to government intervention in monetary policy in other regions. Looser policy may be the best short-term solution to combat the economic consequences of the U.S.-China trade dispute during an extended negotiating period. However, more accommodation may not be enough to counter long-term weakness if an agreement isn't reached. ■