Another Stimulus Miss

Beginning with the Bottom Line:

The Fed tiptoed on and off stage this week without security markets even noticing….by design. However, the US dollar did take notice and ground even higher, stiffening headwinds for US exporters and further challenging S&P 500 earnings assumptions. To get the dollar down, the Fed needs to cut rates more aggressively, something it seems unwilling to do at the moment. Sooner or later, recession will arrive. With deficits already high and interest rates already low, deploying stimulus at scale may require unorthodox activities. The last time around, we had the unorthodox $800 billion American Recovery and Reinvestment Act, an unorthodox zero interest rate policy, and an orthodox $1.3 trillion of quantitative easing to get us going. If the economy slows further while the Fed dithers, Trump could take it upon himself to goose GDP growth and restore US export competitiveness through currency market intervention. Not a prediction, just a pontification. Keynesian economics calls for stimulus to offset economic weakness. The mix of stimulus this next go-around will surely require something else unorthodox. Sign of the times?

The Full Story:

The fireworks anticipated on Fed day (September 18th) turned out to be duds. Lucky Stars! No Fed Chair has received more Bronx cheers at FOMC press conferences than Chairman Jay Powell. His vacillating policy stance combined with his low T rhetoric typically unnerves, if not outright frightens, investors. But not this week! Chairman Powell cut rates .25%, precisely as expected, and delivered a brief and unremarkable press conference. In response, markets closed the day .03% higher and only lower .50% on the week. Well done, Mr. Chairman!

The Fed releases updated projections for inflation, interest rates, and GDP growth four times a year. Let's review September's release. Compared to June's projections, the Fed made almost no adjustments to their 2019/2020 inflation or GDP outlooks but significantly trimmed their interest rate forecasts. Yet, 10 of the 17 Fed Governors called for no additional rate cuts for 2019. This hawkish tilt provided even further appreciation of the US dollar:

Remember, a strengthening dollar increases the cost of US goods and services for buyers abroad. Consider that between Q2 2018 and Q2 2019, the trade-weighted US dollar index rose 3%. Over the same time period, companies that generate more that 50% of their revenue within the US grew revenues 6.3% while companies that generate more than 50% of their revenues outside the US saw revenues decline 2%. The earnings divergence grows even larger with primarily onshore S&P 500 companies seeing earnings growth over 5% while primarily offshore companies saw earnings decline over 11%. Divergences in onshore and offshore economic growth rates contribute as well, but clearly a strong dollar bites for exporters.

US Presidents typically tow the party line on the US dollar…i.e. "A strong US dollar best serves our nation's interests." Yes and no. Nations with weak currencies become suppliers to the nations with strong currencies. The resounding strength of the US dollar tilts our competitive advantage from production to consumption. This weakens our industrial and manufacturing complexes as the rising dollar automates price increases. This also exacerbates our trade deficit as import prices fall and export prices rise. President Trump, never one to tow the line, has openly scolded the Fed for not weakening the dollar through bolder interest rate cuts.

Fortunately for Trump, the US Treasury has the authority to intervene in currency markets whenever "necessary", placing the dollar authority within his hands. Since the dollar decoupled from gold in 1970, there have been periodic interventions of scale. However, each of these interventions (the Plaza Accord, the Louvre Accord, etc.) required agreement and compliance from the Fed and offshore partners. The US dollar market is the largest, most liquid market on the planet at $5 trillion in daily transaction volume. Unilateral actions from the US would need to get pretty creative to even make a dent. Nonetheless, if the economy slows further and the Fed maintains its tight-fisted ways, we could see Trump scrambling for creative stimulus levers like currency intervention.

Have a great Sunday!

Sources: FactSet, FRED, WSJ