

The Fed's head has been turned

"No that isn't true.... it's like.... ok, yeah that is true"

Love Island's Curtis reply to Amy when she accuses him of never dancing with her.

For market watchers obsessed with every twitch and turn in Brexit negotiations, the last few weeks have been pretty quiet as all the key political players either resigned or went on holiday. One might (almost) be forgiven for seeking a bit of escapist drama in Love Island where sudden U-turns of emotion are a nightly occurrence.

This quietness is normal, of course, since all the top-drawer economic corporate news is loaded towards September. This is when we get an insight into how the big economies, and their consumers, have fared over the summer months. We also have the all-important US third-quarter corporate earnings season to look forward to. For many, these seasonally quiet months have justified the annual mantra to "sell in May and go away".



Stock markets may even appear to be a little complacent, sitting as they do near record highs in both the US and UK despite clear evidence of a global economic slow-down. But markets have been supported in no small part by a reversal of the Federal Reserve's interest rate policy.

Yesterday's headlines made much of the US central bank's decision to cut interest rates by 0.25% back down to 2.25%. After all, this is the first interest rate cut since the Great Financial Crisis of 2008. This hiatus came despite the fact that a cut in July was clearly indicated back in June.

One might, therefore, have expected stock markets to rise on the news, but the initial reaction was negative, the US stock market index falling 1%, which suggested expectations of an even bigger cut of 0.5%.

It is worth examining the justification for the cut offered by Chairman Powell and the language used.

Firstly, long-term bond yields had been lower than base rates, indicating the expectation of a recession and, therefore, a future cut. This reflected the market's view that the Federal Reserve had in fact got ahead of itself in raising rates to 2.50%.

Secondly, President Trump had, controversially for any President, been openly critical of the Federal Reserve, insisting that higher rates were hurting the economy unnecessarily.

Chairman Powell countered that Wednesday's cut was in response to "weak global growth, trade policy uncertainty and muted inflation". He added that "global growth was disappointing" and insisted the cut was a precautionary measure to "insure against downside risks". None of these observations came as any surprise. However, the phrase attracting the scrutiny of the media was his comment that this "represents a mid-cycle adjustment to policy". In other words, a significant structural shift.

The old saying goes "Don't fight the Fed" but, on the face of it, it does look like it has caved in to pressure in cutting rates. It isn't supposed to be like this. Interest rate policy has historically turned like an oil tanker in that anticipated changes are typically well flagged. Analysts go to great lengths poring over every subtle change in language contained in committee memos accompanying policy announcements. U-turns of this nature, therefore,

raise questions about the culture and methodology operating behind the doors of the world's most important central bank.

Perhaps the answer for this recent reversal results from the long-term objective to normalise interest rates a decade after the Great Financial Crisis. Of course, one could argue that a base rate of 2.5% is still low in absolute terms and not inconsistent with a growing economy, rising wages and a stock market near all-time highs.

But the moral high ground can be a lonely place and the Chairman of the Fed, Jerome Powell, has been under fire from both the markets and President Trump since taking up his post in February 2018. However, the sight of the head of the world's most powerful financial institution getting pushed into a U-turn by Wall St. and the US President is a troubling one.

To bond market investors, it makes the Fed look "behind the curve", literally.