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Fed divided, dollar liquidity shortage, cautious European banks

- **Fed cuts rates, but three FOMC members dissent**
- **Fed supplies temporary liquidity to the US money market**
- **Drone attack on Saudi oil complex has limited price impact**
- **Eurozone banks take up only small amounts of the new TLTRO III**
- **Some optimism on Brexit and US-China talks**

As expected, the US Federal Reserve cut interest rates by 25bp at their most recent FOMC meeting. During the press conference chairman Powell was noncommittal as regards future actions. More rate cuts may come, or not. President Trump was unimpressed. It is easily forgotten that he criticised the Fed during his election campaign in 2016 for having brought rates far too low, thereby hurting thrifty Americans. I remember being asked about whether a president could force the Fed to raise rates. My response then was that Trump would be, to my knowledge, the first American president in history arguing for higher interest rates. So my forecast was that he would drop the 'the Fed must raise interest rates' rhetoric if he became president. This was not a very difficult forecast, and I am happy to claim "I was right".

What was interesting about the Fed's decision to cut rates was that three voting members of the FOMC dissented, that is, they voted against the decision to cut rates by 25 bp. That is unusual. There are, in principle, 12 voting members at FOMC meetings, seven 'governors', who are based in Washington and who together are the 'board', and five 'presidents', who head up the regional Feds. All governors always vote in every meeting. There are 12 local Feds, or districts, and five of the twelve presidents of these local Feds vote on a rotating basis. There are currently two vacancies at the Board in Washington so there were only 10 voting members at the meeting. To have three people dissenting is, thus, quite significant. In addition, three of the five presidents voted against. What is more, two of the three dissenters had wanted to keep rates unchanged, while one of them had preferred a 50bp cut. So there was opposition in both directions.

What this shows is how divided the Fed currently is. That makes forecasting what they will do in the months and quarters ahead more difficult. We think that economic conditions will weaken and that will trigger two more rate cuts. But the market is pricing in only one more cut while the projections by the FOMC members themselves, expressed in the 'dot plot', suggest the Fed is divided between one more cut and none.

August US industrial production data was firm. Total output increased by 0.6% mom, manufacturing production was up 0.5% mom. The year-on-year rate remains weak at

0.4%, but the recent trend is encouraging. Factory output was up 0.2% mom on average during the last four months while it was down 0.5% mom on average in the first four months of the year. This could be a sign that the industrial cycle is bottoming out, but it is too early to conclude that.

Dollar liquidity shortage

Recent days have seen a sudden surge in US money market rates. In fact, rates moved outside the Fed's target range. My colleague Bill Diviney has written about this several times recently. The Fed has responded by supplying repo facilities, every day since the problem arose. It is assumed that the underlying problem is of a technical nature. Third quarter tax payments have to be made before the end of the month and this is draining banks' liquidity. And apparently, banks have relatively large holdings of US Treasuries. These are liquid assets, but bank reserves at the Fed are, obviously, even more liquid. As such this is not an absolute liquidity shortage, but a matter of the composition of liquidity on banks' balance sheets. The Fed can deal with this matter in several ways. A standing repo facility would seem the easiest, but the Fed has decided against that, at least for now. For now, they are providing ad hoc repos. Further out, the Fed intends to let their balance sheet grow gradually, increasing bank reserves. Let's see what happens in October when the tax payments are out of the way. It is important to bear in mind that liquidity problems can be the first sign of something more problematic. The Great Financial Crisis started as a liquidity problem with some investment funds in 2007. At this stage, there is no reason to be particularly concerned, but we need to watch this closely.

Drone attack on Saudi oil

The recent drone attack on Saudi oil installations has knocked out a considerable part of the kingdom's capacity. Prices shot up, but came down again as market participants decided production capacity would be back up and running soon enough to prevent an oil shortage. My colleague Hans van Cleef has written about this. Our assessment is that this is all fine and good, but that the market is now very vulnerable to any further shock. Any new problem with supply will quickly lead to shortages. Fingers crossed.

A question I have been asked in this respect recently is whether a rise in oil prices could trigger a recession. The answer is obviously yes as this has happened in the past, more than once. The recessions in the 1970s were caused by oil price shocks as was the recession of 1990. Arguably, the steep rise of oil prices before the recession of 2008 may not have triggered the recession, but certainly didn't help either. So, yes, a rise in oil prices could push the economy into recession. But one needs perspective here. In the 1970s oil prices quadrupled over a relatively short period. In 1990 they more than doubled as they did prior to the 2008 recession. It is hard to quantify these things, but my guess would be that it would take an oil price of considerably over USD 100/b to push the economy into recession in current circumstances.

Eurozone banks cautious at the TLTRO III

Eurozone banks took up less than EUR 4 bn at the first of the new TLTRO III facility of the ECB. My colleagues Nick Kounis and Joost Beaumont have written about that. According to Bloomberg, analysts had estimated an uptake of anywhere between EUR 20 bn and EUR 100 bn. It is hard to understand why banks have been so cautious while the terms of this facility are generous. Perhaps they are simply adopting a wait and see attitude. And, obviously, their requirements must have been modest at this stage. Nevertheless, we expect banks to borrow considerably more under this facility going forward, in particular when old borrowings under the TLTRO II have to be paid back and the gross funding requirement rises massively.

Some positive signals

It would seem that the Americans and the Chinese are increasingly willing to engage constructively in trade talks. Having been disappointed before, I am cautious and take a 'I believe it when I see it' attitude. But, I must admit, a narrative can be built around why both sides may be more constructive. As the US presidential elections are getting closer, president Trump must lay the economic groundwork for his re-election. Poor cyclical conditions are a threat to his chances of re-election and an escalation of the trade conflict may cause a weaker economy. I have no idea what the chances are of re-election. But I am surprised by the field of Democratic candidates. Most of them appear to be on the left wing of the Democratic Party. Surely that is going to alienate voters in the middle who may not particularly like Trump, but prefer him over left-wing candidates. It is almost as though the Democrats are handing Trump a second term. But then, what do I know about these things?

On the Chinese side, the leadership probably also prefers to keep the economy going, rather than risking further weakness as a consequence of the trade conflict. Social and political challenges would increase for the leadership should the economy weaken considerably further.

If some sort of agreement is reached, that doesn't mean the conflict is solved. It just means that president Trump is taking a break. An American friend of mine argues that tariffs aren't a tactic, they are a goal. Should he be re-elected, president Trump may quickly re-start hostilities.

Recent noises around Brexit are also more encouraging. The UK government now appears willing to accept an economic border in the Irish Sea to deal with the backstop problem. It is funny that this seems to be the result of the Johnson government losing its majority. This loss has made the Northern Irish DUP (Democratic Unionist Party) irrelevant. Previously, they were crucial in giving the government a majority and therefore they were able to hold the government to ransom. Their demand in exchange for which they supported the government was that there would not be an economic border in the Irish Sea.

Should the UK parliament agree with this plan, a Brexit deal may be within reach. But it is far from certain that parliament will give its OK. By rejecting the proposal, parliament would make Boris Johnson's life more difficult. The opposition now hold a majority and their aim is not to help the PM. To be continued…

Main economic/financial forecasts

GDP growth (%)	**2017**	**2018**	**2019e**	**2020e**	**3M interbank rate**	**12/09/2019**	**19/09/2019**	**+3M**	**2019e**	**2020e**
United States	2.4	2.9	2.2	1.3	United States	2.12	2.16	1.43	1.43	1.55
Eurozone	2.7	1.9	0.8	0.6	Eurozone	-0.43	-0.40	-0.55	-0.55	-0.55
Japan	1.9	0.8	1.0	0.3	Japan	0.07	0.07	-0.10	-0.10	-0.10
United Kingdom	1.8	1.4	1.2	1.2	United Kingdom	0.78	0.78	0.80	0.80	0.80
China	6.9	6.6	6.2	5.8						
World	3.8	3.6	2.9	2.9						
Inflation (%)	**2017**	**2018**	**2019e**	**2020e**	**10Y interest rate**	**12/09/2019**	**19/09/2019**	**+3M**	**2019e**	**2020e**
United States	2.1	2.4	1.8	2.0	US Treasury	1.79	1.77	1.5	1.50	1.50
Eurozone	1.5	1.7	1.1	0.9	German Bund	-0.54	-0.51	-0.8	-0.80	-0.80
Japan	0.5	0.9	1.1	1.6	Euro swap rate	-0.07	-0.10	0.2	0.20	0.35
United Kingdom	2.7	2.5	1.9	1.8	Japanese gov. bonds	-0.21	-0.22	-0.1	-0.10	0.00
China	1.6	2.1	2.5	2.5	UK gilts	0.67	0.64	0.3	0.30	0.30
World	3.0	3.4	3.7	3.3						
Key policy rate	**19/09/2019**	**+3M**	**2019e**	**2020e**	**Currencies**	**12/09/2019**	**19/09/2019**	**+3M**	**2019e**	**2020e**
Federal Reserve	2.00	1.50	1.50	1.50	EUR/USD	1.10	1.11	1.12	1.12	1.15
European Central Bank	-0.50	-0.60	-0.60	-0.60	USD/JPY	108.1	108.0	104	104	100
Bank of Japan	-0.10	-0.10	-0.10	-0.10	GBP/USD	1.23	1.25	1.24	1.24	1.30
Bank of England	0.75	0.75	0.75	0.75	EUR/GBP	0.89	0.89	0.90	0.90	0.88
People's Bank of China	4.35	4.10	4.10	3.85	USD/CNY	7.08	7.10	7.20	7.20	7.50

Source: Thomson Reuters Datastream, ABN AMRO Group Economics.