Weekly Market Summary

June 14th, 2019

Will President Trump Continue Pushing for Interest Rates Cuts to Reduce the Harm Caused by His Domestic & Foreign Policies?!?

Fadi Nasser - Deputy Chief Investment & Treasury Officer

Six full weeks have passed since Federal Reserve officials last met to debate the state of the US economy and decide on the appropriate level of short-term interest rates. At their last meeting on May 1st, the Federal Open Market Committee ("FOMC") kept policy unchanged (benchmark Fed funds rate target at 2.25% -- 2.50%) whilst making a small downward adjustment to the rate paid by the Fed on banks' excess reserves. And though very little in the statement changed with regards to their commitment to be "*patient*" on future rate moves, the characterization of the current economic situation was one of strong growth, but very little inflation (although Fed Chair Powell did characterize the current inflation shortfall as being a function of "*transitory*" factors). For investors who had turned exuberant on asset prices, piling up on bond and equity investments in the hope that a persistent shortfall on inflation - and growing pressure from the White House - would be a sufficient cause for a rate reduction in the not-too-distant future, it was a clear reminder that FOMC members weren't yet reading from the same page! As a result, Treasury yields swung from lower to higher whilst stocks headed sharply lower!

As a reminder, the Federal Open Market Committee ("FOMC") is the monetary policy-making body of the US Federal Reserve. It schedules eight meetings per year, one about every six weeks or so (the Committee may also hold unscheduled meetings as necessary to review economic and financial developments). By law, it conducts monetary policy to achieve its macroeconomic objectives of maximum employment and stable prices; Usually, that is accomplished by adjusting the level of short-term interest rates in response to changes in the economic outlook. However, from 2008 until 2013, the FOMC also used large-scale purchases of Treasury securities and securities as a policy tool in an effort to lower longer-term interest rates and thereby improve financial conditions and so support the economic recovery. Following each regular meeting, the FOMC issues a policy statement that summarizes the Committee's economic outlook and the policy decision at that meeting. The Fed Chairman holds a press briefing after every FOMC meeting (prior to 2019, it was only 4 times a year) to present the FOMC's current economic projections and to provide additional context for the FOMC's policy decisions. A full set of minutes for each FOMC meeting is published three weeks after the conclusion of each regular meeting, and complete transcripts of FOMC meetings are published five years after the meeting.

So What Should We Expect at the Upcoming (Wednesday, June 19th) FOMC meeting?

Just few weeks back, investors thought there was a very small chance that the Federal Reserve would cut interest rates at their meeting in late July (a rate move at the June meeting still seen as premature). But now, following the latest release of weak US economic data (Payroll, Factory Output, Home Purchases, Inflation, ...) and an escalation in the trade war that has prompted fears of further hits to global growth, the picture has radically changed; The probability of a cut to the US central bank's target interest rate at the July 31st FOMC meeting stands currently at 90%, according to futures prices, up from 18% at the start of last month (for the June 19th meeting, the probability of a 25 bps cut remains a low 30%). Bets that the Fed will move sooner, rather than later, come as trade war frictions and bad political rhetoric have developed into a tiresome reality for investors and after the administration of US president Donald Trump opened up new fronts in its China-focused trade war, threatening to increase tariffs on Mexican imports (put off last Sunday) and announcing that it will terminate duty-free imports from India on roughly 2,000 products. Rate cut expectations were also bolstered after a speech in Chicago on June 4th by Fed Chair Jay Powell, in which he opened the door to potential easing if needed because of heightened US trade tensions with China and Mexico. The Fed is "*closely monitoring*" the impact of trade developments and would "*act as appropriate*" to sustain the economic expansion, Powell noted during his note.

One could argue that Powell never once mentioned the phrase *"rate cut"* during his speech or even anything close to the "*downward policy rate adjustment may be warranted soon*" comment from St. Louis Fed President James Bullard a day earlier. Obviously at this point, the idea that the Fed could just as likely raise interest rates as lower them is just not true! Policy makers scrapped that notion in March when they dropped their median projection to zero interest-rate increases in 2019 from two previously and therefore it is fair to assume that when the central bank next moves, it would certainly be a rate cut. But divining precisely when that will come is nothing but a wild guess at this point in time!

Investors are well acquainted with the advice of "*never fight a central bank*". Another market wisdom is "*don't ignore the bond market*" when it sends a strong message. And speaking of bond markets, this morning they are SCREAMING for a rate cut (both 2-year and 5-year UST yields last at 1.80% versus a 3-month US LIBOR @ 2.40%, a stunning 60 bps yield inversion!). One can look at the bond market and think it has run well ahead of fundamentals, but buyers of sovereign paper are being spurred by the likely damage inflicted on global trade flows and business investment as the tone between Washington and Beijing continues to deteriorate. Nevertheless, the bond market is not the economy! It will most probably take another set of weak data points to truly motivate the Fed to drop interest rates during the second half of this year; Powell continues acknowledging that the U.S. has a "*strong labour market and inflation near our symmetric 2% objective*," and the Fed Chair is aware that using monetary policy to turbo-charge inflation and asset prices comes with its own set of risks. Not to mention that an improvised "*insurance cut*" could very well backfire and spook investors (igniting the usual "*Does the Fed Know Something We Don't*"). Still, that would not forestall market expectations of the need for a pre-emptive rate cut by the Fed this summer, which in turn means low Treasury yields and the prospect of a sustained curve inversion.

And whilst most investors get increasingly convinced that the Fed has their back (the so-called "Powell Put"!), we remain firmly in the camp that argues - at least for now - that the Fed should wait, owing to the inherent uncertainty over trade negotiations and the trajectory of how slowing economic activity ultimately plays out. Central banks are used to having to factor in changes of policy from their governments that will affect economic growth, notably alterations in the fiscal stance. But rarely in an advanced economy is such policy announced as a complete surprise and with such an unclear chance of actually being implemented. Cutting interest rates in direct response to such announcements, or indeed to market movements that follow them, would be unwise, especially when it is not too clear how effective interest-rate cuts will be in fixing Trump's trade disputes. Instead, the Fed should make clear it will change interest rates as and when it is warranted by the real data, by evidence of price pressures and by reliable forward-looking indicators of future activity. That should prove disappointing to bond traders positioning for imminent interest-rate cuts and would assuredly trigger immediate negative and naïve tweets from the US President. The latter has wasted no time in past weeks (& months) criticizing the US Federal Reserve - saying the central bank was being "*very, very disruptive*" by raising interest rates too fast and giving China an edge in trade negotiations as a result (previously Trump had also noted that the US central bank doesn't "*listen*" to him and added that "*they don't have a clue*", called the Fed his "*biggest threat*", said he was "*not even a little bit happy*" with chairman Jay Powell, described the Fed's decision to raise interest rates in December as a "*big mistake*").

To conclude, we expect the FOMC to keep its policy target rates unchanged at 2.25% - 2.50% at next week's meeting. We also anticipate the FOMC statement and Chair Powell's ensuing comments to somewhat downgrade the economic outlook and point to a further shift away from the Fed's current neutral and patient policy approach to one that sees more downside than upside risks to the economic outlook. The June meeting will also provide an updated summary of economic projections and "Dot Plots". There too, Fed officials will likely drop the one hike implied by the 2020 median dot in the March projections and more likely bring downward revisions to their growth and core inflation projections for this year and next.

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