RBC Global Asset Management

US Fixed Income Team

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Fed Update - Fighting the Curve

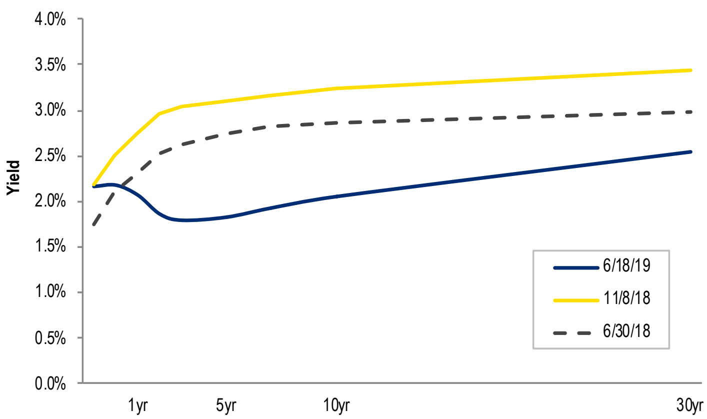
The Federal Reserve (Fed) kept rates steady amidst stronger than usual scrutiny as it convened the Federal Open Market Committee (FOMC) for meetings this week.

Fed Chair Jerome Powell and his colleagues are facing the strongest expectations of rate cuts since they began gradually raising the Fed Funds Rate in December 2015. Since then, the Fed Funds Rate has climbed from a range of 0.00-0.25% to its current range of 2.25-2.50%, a total of nine increases of 25 basis points (bps). During that time, the Fed has emphasized a patient approach with an emphasis on data-dependent monetary policy adjustments. Following the last rate increase in December 2018, the Fed gave forward guidance through their so called “dot plot” projections that they expected another three 25 bps rate increases in 2019.

Since the turn of the year, economic and geopolitical headwinds coupled with heightened market volatility have forced the Fed to reassess their approach to monetary policy. Of particular concern has been the unpredictability of the continuing deliberations between the US and China on trade negotiations. The situation took a concerning turn in May, when trade talks seemingly fell apart and the US threatened to levy additional tariffs, while China vowed to retaliate. Markets reacted negatively, with a flight to quality that saw Treasuries rally strongly, pushing down yields.

The Treasury curve has fallen sharply from its peak in early November with the 10-year Treasury down over 100 bps, from 3.24% to 2.06%, as of June 18th (Figure 1). More strikingly, the curve has inverted with the spread between the 10-year and 3-month yields now -11 bps (Figure 2). Historically, inverted curves have preceded recessions by 6-24 months. Further dimming the outlook has been the prospect of slowing global growth. Around the world,

Exhibit 1: Treasury Curve Change



Source: RBC and Bloomberg as of June 18, 2019

purchasing manager indexes, which are often viewed as a leading indicator of economic health, have been declining. Additionally, the International Monetary Fund’s recent projections of global GDP have been revised lower.

Clearly, global economic and geopolitical conditions as well as nervous market expectations are sounding alarm bells for the Fed to consider a more accommodative monetary policy. However, from a domestic perspective the economic picture is less worrisome. Even as US GDP growth is expected to slow to around 2%, the economy continues to show stable fundamentals with no clear signs of excesses. The US is clearly in the late stages of the economic cycle, but there are no clear signs that the long recovery following the Great Recession is in imminent danger of faltering in the near future.

Job growth continues to be strong. The three-month moving average of monthly nonfarm payrolls has consistently been above 150,000 for nearly seven years and unemployment remains firmly below 4%. Consumer confidence remains high and low interest rates are supportive of rate-sensitive sectors like housing. Finally, inflation continues to be stable below 2%.

Even as markets increasingly expect the Fed to cut rates before the end of the year, the stable US economic picture can still afford room for the central bank to bide its time in the near term. The FOMC statement following the meeting acknowledged that uncertainties to the outlook have increased, further stating that “the Committee will closely monitor the implications of incoming information for the economic outlook and will act as appropriate to sustain the expansion.” Also notably, the statement removed the word “patient.” At the news conference following the meeting Powell reiterated, “In light of increased uncertainties and muted inflation pressures,” the FOMC is no longer patient.

The FOMC’s updated “dot plot” projections are now factoring in a 25 bps cut by the end of the year, which is more in line with market expectations of one or two 25 bps cuts. While a rate cut now seems likelier than not this year we believe that expectations have skewed too dovish. It’s not unreasonable to see yields moderate if the economic picture continues to be stable and trade talks with China take a more favorable turn.

Exhibit 2: 10 Yr/3 Mo Treasury Spread

Source: RBC and Bloomberg as of June 18, 2019

Overall, the Federal Reserve is not in an enviable position. What once seemed like smooth sailing has turned into choppy waters. Ultimately, the members of the FOMC are beholden to their dual mandate of maximum employment and stable prices, but they also have to project a stance that shows that they are paying attention to current volatility and geopolitical conditions. We expect that the Fed will continue to be data-focused in their approach while attempting to ease any concerns that monetary policy has fallen behind the curve.

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