RBC Global Asset Management
BlueBay Asset Management

Update: Federal Reserve Interest Rate Cut

Powell offers insurance, Trump lights a flame

While the pre-emptive rate cut should provide some protection, whether monetary policy measures will be enough to offset downside risks remains an unanswered question for investors.

The Federal Reserve (Fed) cut US interest rates for the first time since the financial crisis as a form of insurance against downside risks from weak global growth and trade policy uncertainty. The market was mildly disappointed that Fed Chair Powell suggested only a couple of insurance cuts would be forthcoming, rather than the several priced prior to the Fed meeting.

End of quantitative tightening

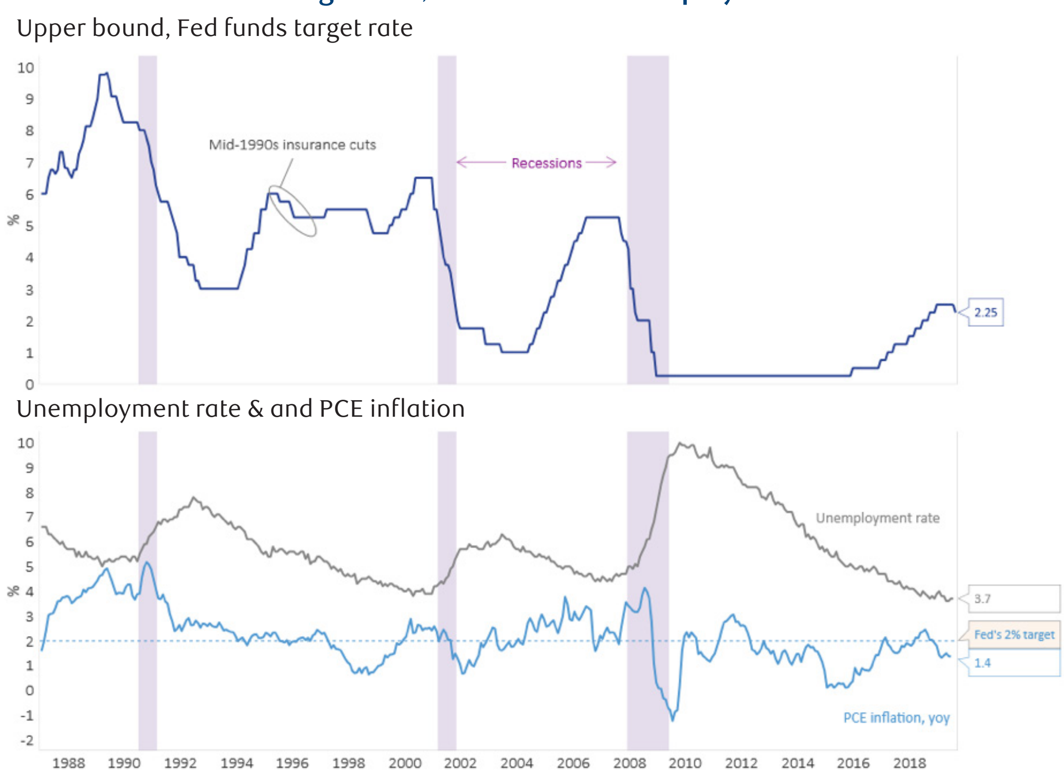
The FOMC – the Fed's interest-rate setting committee – cut the target range for the Fed funds rate by 25 basis points (bps) to 2-2.25% on 31 July. The Fed also brought to an early end the run-off in its balance sheet – so-called 'quantitative tightening' – consistent with the shift to an easing bias.

President Trump was less nuanced in his displeasure and tweeted "...As usual, Powell let us down".

A few days later, following the failure of trade talks earlier in the week, President Trump brought to an abrupt end the 'truce' in the US-Sino trade war reached at the G20 Summit in June by announcing additional tariffs on Chinese imports with effect from 1 September.

As any insurer will tell you, offering protection against losses can encourage the very behaviour that leads to paying out on the insurance policy.

Exhibit 1: Fed funds target rate, inflation and unemployment



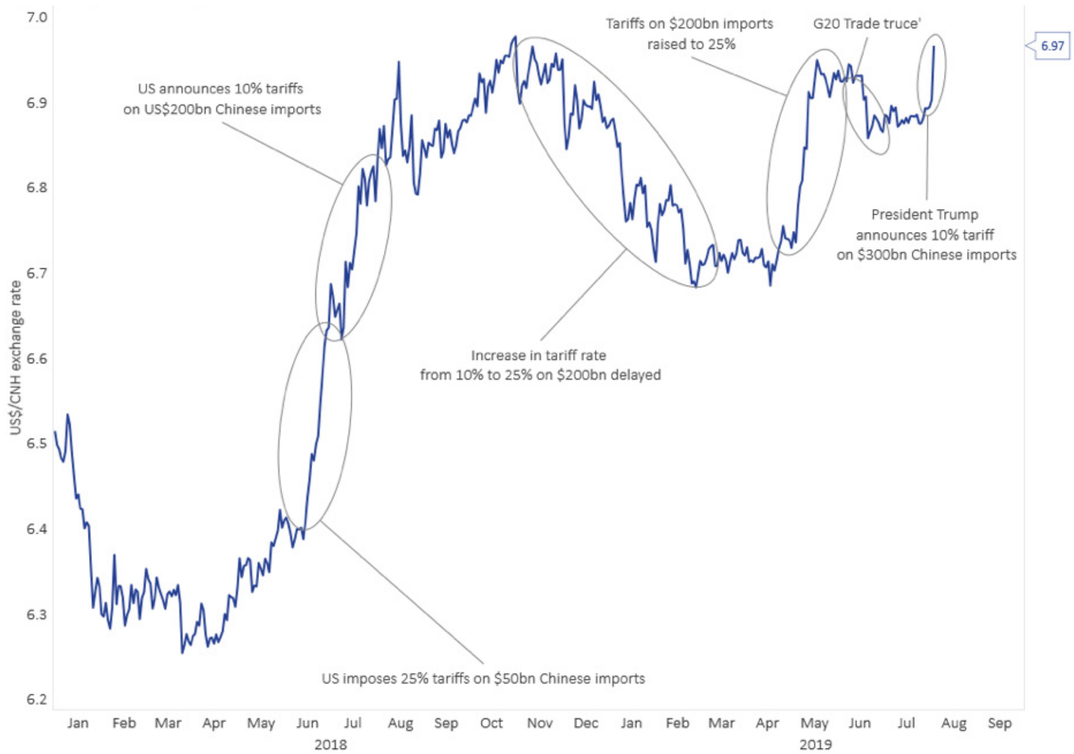
Source: Macrobond; US Federal Reserve; shaded columns denote NBER-dated US recessions; latest data at 08.02.19

The immediate market reaction was one of disappointment with a decline in US equity markets, albeit modest, and a pop higher in the US dollar.

The market disappointment reflected a worry among many investors that the US is 'late cycle' and that only a full rate-cutting cycle by the Fed will stave-off recession over the next 12-18 months.

The current US economic expansion is the oldest on record, although in output terms it has been unspectacular. But expansions do not die of old age, but from a heart attacks induced by private sector imbalances, Fed tightening monetary policy too aggressively or an external economic shock. As Chair Powell noted, there is little evidence of significant imbalances in the private sector that suggest a pending recession. The risk of over-tightening by the Fed is evidently less, with the extent of Fed easing understated by some market participants.

Exhibit 2: PCE inflation has struggled to meet the



Source: Macrobond; PIIE Trade & Investment Policy Watch; latest data at 08.02.19

Even assuming only one more 25bps insurance rate cut by the Fed, it would still imply a near 100bps of easing relative to Fed and market expectations a year ago. The Fed believes that, as in the mid-1990s, a modest policy easing in response to external weakness will be enough to extend the current US expansion beyond 2020 (conveniently a presidential election year).

Presidential pressure and the growth conundrum

But the Fed is caught between a rock and hard place – uncertainties around global growth and trade are not going away any time soon, yet the US economy remains in relatively good health.

Despite weaker manufacturing and business investment, the US economy is generating plenty of jobs, a confident consumer is spending and the recent bipartisan agreement on the budget and debt ceiling implies some further modest fiscal easing. And though inflation remains below the Fed's 2% target, some of the softness earlier this year is transitory and it is likely to converge to 2% by the end of the year.

Against such a backdrop, it is not surprising that there were two members of the FOMC that dissented against the rate cut and that during the press conference, Chair Powell pushed back against market expectations (and President Trump's demands) for an aggressive rate cutting cycle.

Tariff truce terminated

President Trump announced on Twitter new tariffs of 10% on around USD300 billion of Chinese imports to come into effect on 1 September. Coming on top of the current 25% tariff on around USD250 billion of Chinese imports, the trade-weighted US tariff on imports from its largest bilateral trading partner has gone from 3.1% in 2017 to 21.5% today (source PIIE, August 1, 2019).

Beijing has pledged to respond with countermeasures following the lack of progress in trade talks between the US and China earlier this week in Shanghai. For investors, a key gauge of Beijing's readiness to escalate beyond 'tit for tat' tariffs on US imports (that at around USD150 billion are less than a third of China's exports to the US), is the value of the Chinese currency – yuan (CNH) – against the US dollar.

A large devaluation the yuan is unlikely because it poses too great a risk to China's financial stability. But with the USD/CNY breaking through the symbolic 7.00, it is nonetheless a source of market volatility as well as adding fuel to a stronger US dollar.

Can policy prevail?

Policy easing by central banks has underpinned the rally in risk assets so far this year, despite the slowdown in global growth and heightened trade tensions. The question for investors is whether monetary policy will be sufficient to offset the downside risks to global growth and corporate earnings from trade policy uncertainty and prevent the downturn in manufacturing from dragging down the consumer and services sectors of the economy that in Europe and Asia, as well as in the US, remain solid.

Credit is less sensitive to corporate earnings disappointments than equity markets and with default rates set to remain low against the backdrop of positive – albeit mediocre – economic growth, our bias is to generate carry by moving down the capital structure in higher-quality issuers, as well as from assets that have lagged the rally such as CLOs (collateralised loan obligations).

Credit in emerging markets and local debt markets with high real interest rates and cheap currencies also offers value, in our opinion, despite periodic episodes of volatility from trade policy uncertainties and global growth fears.

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