Global Asset Management

BlueBay Asset Management

Portfolio Manager Perspectives
Mark Dowding's Global Macro Update

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Jerome Throws in the Powell

The Fed bows to political pressure giving Trump more ammunition for his global trade war.

The Federal Reserve (Fed) cut rates by 25bp this week, as widely expected by markets. Interestingly, the FOMC left its domestic economic outlook broadly unchanged in its statement and follow-on remarks in the Q&A suggest that growth is seen remaining at or above trend in the second half of 2019.

With a number of economic data releases above consensus in the past month, it is possible to wonder whether Powell would have announced a policy move this week were it not for the fact that he had felt pressured to pre-commit to move in this direction back in June.

Political pressure for extended expansion

TAt that time, trade worries were peaking, data was softening and the Fed found itself under increasing pressure following a barrage of criticism from the White House.

Consequently, it seemed as if there was some sense of reluctance in Powell's narrative this week and a desire that markets should view this change as a mid-cycle ease aimed at extending the economic expansion, rather than the start of a more protracted rate cutting cycle.

In explaining the Fed's decision, it seemed that the narrative was firmly anchored in potential risks coming from elsewhere in the global economy, without inflation seeming to be a driving impetus. Core PCE inflation, at 1.6%, remains below the Feds target, but after falling earlier in 2019, it now seems to be on an increasing trend with the past three months running at an annualise 2.5% rate.

The Fed Chair seemed careful not to pre-commit to further easing measures, though also noted that it would be very unusual for any central bank to ease policy once, on the basis of 'one and done'.

However, although the initial reaction to the Fed's hawkish cut was a relatively muted one, this was soon literally 'Trumped' by tweets from the President reigniting trade tensions with China by adding additional tariffs, in response to a perceived stalling in negotiations with Beijing. This move caught markets by surprise as most commentary — and indeed our own feedback from policymakers — was that a stalemate was likely to persist, even if progress towards a trade deal looked as if it were stalling.

In understanding Trump's motivation, it has been instructive to look at polling data, which shows that he enjoys quite a lot of support in his approach — notably so in the key swing states he needs to win next year.

It is also interesting that Democrat candidates are towing a hawkish China line and so the current Administration will probably be convinced that trying to be tough on China is the smart thing to do — just as long as this doesn't derail the economy or the equity market.

Following spending deals agreed on Capitol Hill, US fiscal policy is set to ease further in the coming year and arguably now that Powell has acquiesced to Trump's desire to start lowering rates, it could be argued that fiscal and monetary policy are supplying the ammunition for Trump to pursue his trade wars. This makes for an unpredictable backdrop and, in the short term, a flight to quality has seen Treasury yields fall and risk assets under pressure.

However, at the same time we continue to hold to the view that US domestic growth momentum is likely to remain strong — especially away from the manufacturing sector.

In this context, we are not inclined to change our macro view substantially at this point. Instead, we are inclined to look for opportunities should markets start to overshoot.

Across the Atlantic

Eurozone yields continued to grind lower with 10-year Bunds at a new record-low yield of -0.49%, as European data continues to lag the US.

Investors are inclined to believe that the ECB will need to 'out-dove' the Fed at its September meeting, though we remain a little concerned that these bullish expectations may be running ahead of what is justified.

In the periphery, profit-taking saw Italian spreads back to 210bp versus Germany, while corporate CDS indices also moved a little wider with equities falling.

Elsewhere in summertime markets, Spain has been a focus as new elections become likely as the coalition has fractured — yet we see this having a limited impact on Bonos in the near term.

Irish bond spreads were also in the spotlight on worries that Ireland would be the biggest loser were a 'No Deal' Brexit to occur later this year.

Brexiteers leave 'no-deal' complications for Autumn consideration

In the UK itself, Parliament is now on summer recess and so newsflow will be relatively light over the next few weeks. However, a strong bounce for the Conservative Party in opinion polls is increasing the prospect of an election being announced in September, to take place at the end of October.

We believe that a UK election could ultimately lead to victory for a Labour / Liberal / SNP coalition and that Prime Minister Johnson would rather fight a campaign in a honeymoon period, shortly after taking office and before the Labour Party possibly look to remove Jeremy Corbyn as its leader.

With the Conservatives operating with no effective majority, a vote does not seem far off and with this prospect, we believe that Brexit will almost certainly need to be delayed beyond 31 October, despite claims to the contrary.

Moreover, the UK is a long way from being ready for a hard Brexit — something highlighted in our recent meetings with policymakers in Europe and North America.

Indeed — even looking at an industry such as fishing, there seems bemusement that the UK has not even yet applied to become a member of the North Atlantic Fisheries Organisation (NAFO), despite this body having its headquarters in London.

Fishing industry experts highlight how UK boats will be barred from fishing in international waters, as the UK doesn't have any quotas (and the EU is unlikely to surrender part of its quota to the UK), and that a hard Brexit will also mean that UK boats can't export fish to the EU in a hard Brexit without regulatory approvals, which will take months to put into place.

The lack of preparedness in the UK seems truly shocking to senior policymakers in trade circles and there is a disbelief that UK policymakers can't see how severe the impacts of leaving the EU without a deal would be.

Election speculation

In our opinion, an election in the UK, leading to a change of government and a possible further EU referendum, could see Gilt yields substantially higher and could lead to a reversal in the pound.

By contrast, an increased Conservative majority could lead to a hard Brexit withdrawal — which may need to be delayed into 2020 for operational reasons.

A hard Brexit would see the pound fall and inflation rise. We also think it would lead to a massive fiscal response in order to stabilise the economy.

Against this backdrop, we are sceptical that the BoE will cut rates or deliver more QE and on this note it is interesting to observe that nearly all of the senior policymakers we meet globally are arguing for more of a monetary to fiscal policy hand-off.

There is a sense that cutting interest rates, which are very low or in negative territory, achieves very little. Further QE at this point only creates asset price inflation, which serves to exacerbate income inequality.

We feel that yields in Europe could be approaching the lowest points they will reach — even if, in the case of the EU, the path towards expansionary fiscal policy is likely to be a slower one given German intransigence.

Maybe it is ironic — if only Berlin (dinosaurs) were to realise that issuing more debt when your bond yields are negative serves to cut your debt-to-GDP ratio — perhaps they too could become more in favour of this one day!

Looking ahead

It is clear to us that policy will be data dependent and given that the unpredictable path of trade negotiations, the coming month could be one with some volatility and uncertainty.

Our sense had been that data should have bottomed-out and may start to show signs of improvement, though — as we have seen with the recent Fed meeting — tweets can have a more material impact than monetary policy decisions at the current point in time.

Taking a step back

It has interested us how the Fed has been seemingly eager to draw parallels between the current economic situation with the 1990s expansion, which saw the Fed cut several times in 1995 and 1998 in response to a mid-cycle slowing in growth.

Such cycles support the notion that single rate cuts are unlikely — yet with absolute interest rates substantially lower than was the case during the 90s, the room to ease is clearly much more constrained today than it was back then, with the funds rate standing at just 2.1%.

We are also interested to note that in both cases, growth rebounded strongly following a policy ease — yet unlike in 1995 and 1998, growth in 2019 remains at or above trend, rather than below it.

In both instances, it was not long after the first rate cut when rates started to head back up again, with 21 months and nine months respectively marking the timing of the first hike following on from the period after the first rate cut.

We might argue that the Fed didn't need to ease — but that doesn't really matter. They have cut rates and even if time shows that they didn't actually need to do so, then the costs from taking this step are likely to be pretty minimal.

That said, we are sceptical that rates will continue to fall as forward markets are inclined to discount. Arguably, on this occasion, we have seen how Trump pressure got Jerome to throw in the towel — but looking forward, we believe that the Fed will be more wary of boxing itself into a difficult corner.

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