RBC Global Asset Management

US Fixed Income Team

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An Insurance Cut?

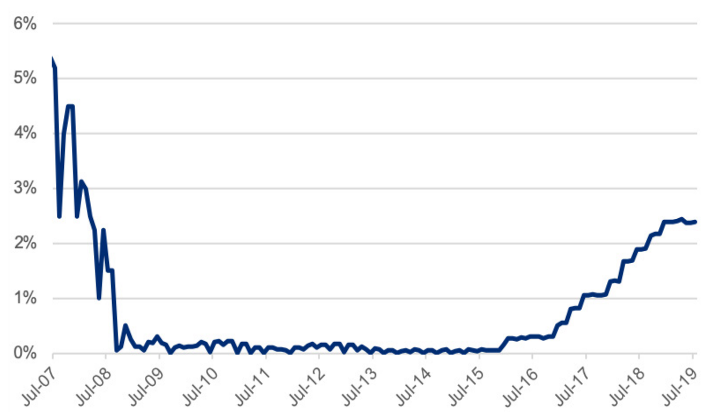
The Federal Reserve voted to cut the Fed Funds Rate by 25 basis points (bps) to a range of 2.0-2.25% as the Federal Open Market Committee (FOMC) concluded its July meeting.

The FOMC also announced the conclusion of their planned balance sheet reduction on August 1st, two months sooner than anticipated. Market expectations of rate cuts have been growing in recent months over concerns that the Fed's monetary tightening policy had moved too far and Fed officials have indicated that they are prepared to take action to sustain the economy. The cut marks the first rate cut in over 10 years during which time the US has experienced one of the longest, and slowest, economic expansions in its history (Exhibit 1). In reaching their current policy conclusions, the FOMC cited "the implications of global developments for the economic outlook as well as muted inflation pressures" as the rationale for their decision.

Markets are concerned that the current economic cycle may be reaching its end as a slew of global economic and geopolitical headwinds are weighing on the outlook. Globally, growth is showing signs of weakening, as Europe and China struggle with slowing economies and other central banks embark on their own monetary easing cycles. As trade talks between the US and China seem to be back on track, the situation, and its implications to global trade, is far from resolved. Lastly, growing geopolitical concerns surrounding US-Iran tensions and Brexit are further clouding the global picture.

While the Fed has acknowledged that they are paying attention to the global picture, its implications to the domestic picture are less certain. Indeed, the US remains an outlier with its relatively rosier economy. Recent second quarter GDP of 2.1% gives credence that the economy is slowing from the above 3% growth that we saw in 2018, but still beat market expectations. Employment numbers continue to be strong as June nonfarm payrolls beat expectations, with 224,000 jobs added, and current expectations are for 165,000 to be added in July. The labor market is also buoyed by consumer demand, as retail sales and personal consumption remain strong.

Exhibit 1: The last time the Fed voted to cut rates was September 2008



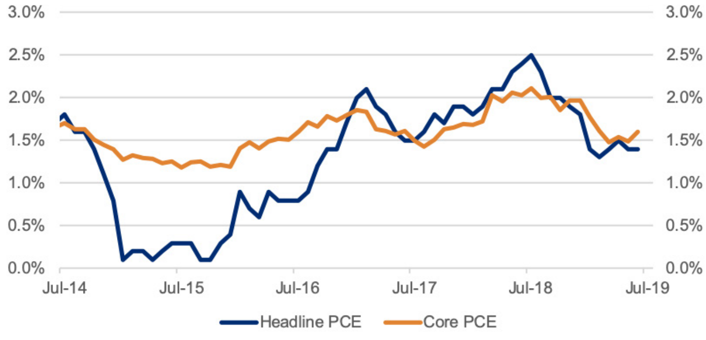
Source: Bloomberg as of July 31, 2019

Inflation was a key factor in the Fed's decision making. As part of the Fed's dual mandate of stable employment and price stability, they have targeted an annual inflation rate of 2%. However, the Fed's preferred measure of inflation, the Personal Consumption Expenditures (PCE) Index, has persistently struggled to reach that target (Exhibit 2). The most recent June core PCE results show an inflation rate of just 1.6%. This year's weak inflation numbers as well as falling inflation expectations (Exhibit 3) are primary reasons that the Fed felt comfortable in delivering a 25bps cut. Even as they expect inflation to reach their 2% target in the near term, there is little concern of the economy overheating.

Looking forward, market expectations are for continued monetary easing by the Fed and another 50bps of cuts going into 2020. However, the current economic conditions are not calling for as much easing as the market wants. Additionally, if the Fed delivers on these cuts while the domestic economy is still seemingly in good shape, they risk not having enough ammunition to combat a legitimate economic downturn.

This tension between market expectations and the Fed's data dependent approach sets the stage for increased volatility going forward. There is a risk that the Fed is not going to deliver all the monetary easing that the markets expect. However, if the Fed intends for this cut to be "one and done," they face the challenge of convincing markets that they are right, while also reconciling their own dissenting views. Two FOMC members dissented in today's decision, both favoring no cuts, which indicates that even the Fed is conflicted about future policy decisions. The Fed took this opportunity to deliver an "insurance cut" against global weakness. They left the door open for further cuts, particularly if inflation remains muted, but they are clearly positioning themselves to be flexible as future conditions warrant.

Exhibit 2: PCE inflation has struggled to meet the Fed's 2% objective



Source: Bloomberg as of July 31, 2019

Exhibit 3: Market Expectations of future inflation have moderated between 1.5% & 2.5%

Source: Bloomberg as of July 31, 2019

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