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INSIGHT

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U.S. Rates Update January 2019

MARCELA MEIRELLES | 7 FEBRUARY 2019

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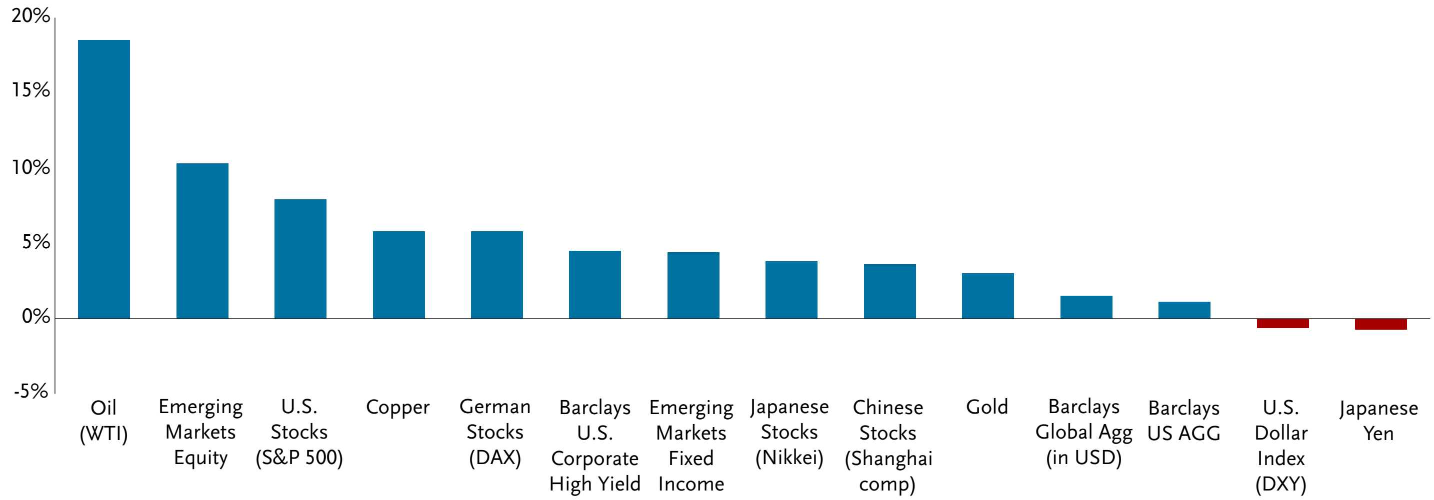
"Flexible", "prepared to adjust," "patient," these were the words that consolidated the Federal Reserve's 180 degree shift from hawkish remarks made just last October. Reference to further gradual increases of the federal funds rate was dropped from the post-meeting statement. So was the reference to "balanced risks." The committee felt the need to publish a separate statement on the balance sheet, confirming they will adjust as the data change. In the Q&A session, Chairman Powell could not articulate what had changed since the December meeting. It could be simply the Fed is finally listening to the market, which has been flashing warning signs over the past few months. In a nutshell, the shift in Fed communications cements the transition to a more dovish outlook for quantitative tightening around the world. From U.S. to Australia, investors are evaluating global central banking and refocusing the discussion from "when will be the next hike" to "when will they cut".

Markets cheered the change in Fed communication, and risk assets rallied, despite scarce positive news on global economic activity. The term typically associated with this market dynamic is "Goldilocks:" a global economy that is far from buoyant and with limited to nonexistent inflationary pressures but doing well enough to provide a window of opportunity for risk assets to perform well. The Fed signed off on this scenario and asset prices responded accordingly.

U.S. corporate high yield index spreads tightened 96 bps during the month, largely erasing the December selloff. U.S. investment grade credits also rebounded, with index spreads tighter by 21 bps. Commodities priced a brighter global outlook, with oil (WTI) up 18.5% and copper up 6%. Safe haven currencies predictably underperformed, with the Japanese yen down -0.7%. The U.S. Dollar Index (DXY, measuring the U.S. dollar against a basket of developed market currencies) lost -0.6%. Emerging market bonds had the best monthly performance since 2011, with the U.S.-dollar-denominated bond index soaring 4.4%.

January 2019 Total Returns (%)



Source: Bloomberg

There is still debate on what prompted the Fed policy committee to convey a more cautious message to the market. The causes of the intense market selloff in December, both in credit and equities, are likely still under review by the Fed. The institution could now be less confident on a host of fronts: the impact of the balance sheet runoff, elevated fiscal deficits, slowing global growth and subdued inflation. In the press conference, Powell suggested "common sense risk management suggests patiently awaiting greater clarity."

On the economic data front, the latest prints suggest that indeed some caution in policy normalization is warranted. Looking across a range of indicators, the U.S. economy is still doing well. But some sectors could be feeling the pinch of a decelerating global economy, higher import tariffs and overall uncertainty due to the U.S. government shutdown and trade wars. The ISM manufacturing index eased more than expected, with noticeable declines in prices paid and new orders. This manufacturing downturn has been broad based and even more pronounced on a global basis, including sharp slowdowns in China, Germany, Australia and Italy.

In the U.S., existing home sales again surprised on the downside, dropping 6.4% MoM. A range of inflation gauges continue to point to muted, if any, inflationary pressure. Headline CPI dipped below 2%, and core inflation remained steady at 2.2%. Labor market indicators continue to paint a picture of a healthy environment for job seekers, but there is less evidence that the market is getting "hotter." For example, surveys indicate that, on the margin, employers are now less worried about not finding a qualified candidate. Average weekly earnings gains have stabilized after solid gains in 2017/18.

On the fiscal front, the cyclical component of the tax reform will be less of a tailwind in 2019 compared to the previous year. Funding high government deficits could crowd out financing for private investments. Putting all these factors together and then looking ahead, the U.S. economy could behave more and more in line with a late-cycle dynamic. The Fed's apparent decision to ease the pace of monetary tightening might simply be an attempt to not bring forward this inevitable deceleration. ■

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