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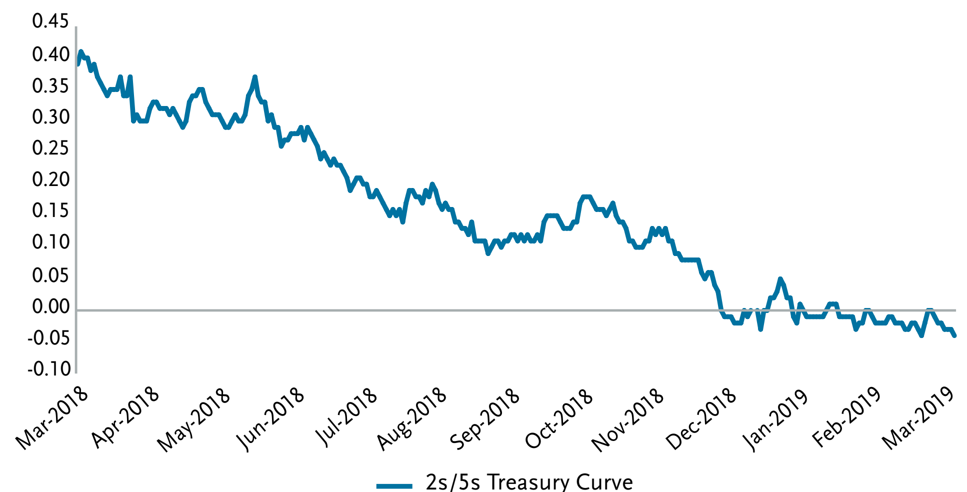
# INSIGHT

MONTHLY COMMENTARY

## U.S. Rates Update February 2019

**MICHAEL Y. PAK, CFA** | 13 MARCH 2019

The ebullience in risk markets carried over into February primarily fueled by positive headlines around U.S. trade talks with China (extension of the March 1 deadline when tariffs on some goods would have increased to 25%) and the end of the U.S. government shut down. Stock markets from the U.S. (S&P 500 +2.9% MTD) to China (Shanghai Composite +13.8% MTD) rallied on the headlines as equity investors cheered the removal of two risks that had been hanging over the market since the start of the year. Although U.S. Treasuries sold off during the month with the risk-on move, they firmly remained in their long-held range. More importantly the rates markets are still pricing in Fed cuts as evidenced by the continued inversion in the 2s/5s Treasury curve (below) and Fed Fund futures which imply a cut by mid-2020.




Source: Bloomberg

This dichotomy between the performance of risk and risk-free markets is an interesting one. The Treasury market remains more focused on the looming risks on the horizon, namely: 1) continuing mixed economic data in the U.S., 2) weaker industrial readings across Europe and China, and 3) emerging market economies dealing with a stubbornly strong dollar. Additionally, the Fed has clearly moved its inflation mandate to the forefront, which was reaffirmed by Powell's mid-month

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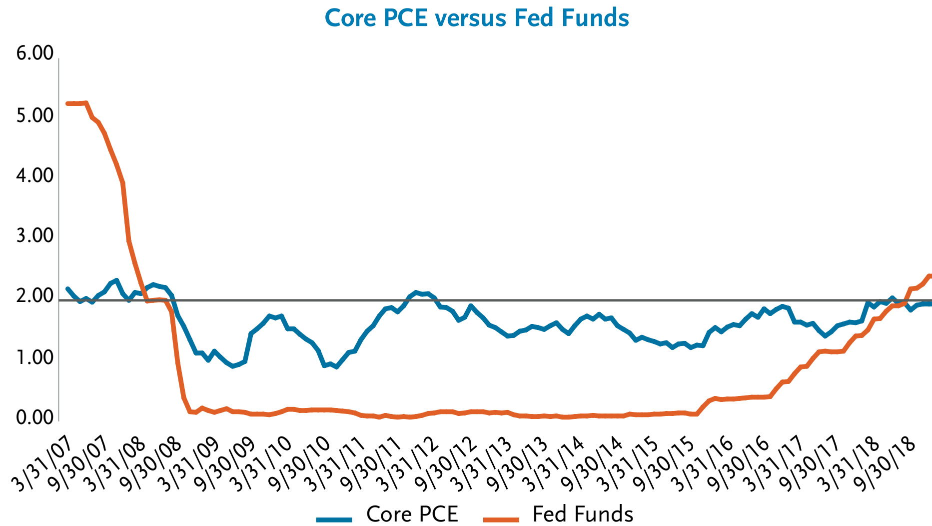


Source: Bloomberg

testimony and by the release of the January FOMC minutes. Barring a rapid deterioration in financial conditions, the Fed is indeed likely to remain patient (therefore rates range-bound) as it takes its clues from the market and any shifts in inflation data/expectations. Although the Fed stated it is not necessarily looking for a higher inflation target per se, that would not preclude it from adjusting its inflation framework to more consistently hit the 2% objective.

The last point on revisiting the inflation framework is an interesting one, which has recently been advocated by numerous Fed officials, although Powell remarked that a "high bar remained for any fundamental change." The Fed's plan to review the framework this year is primarily motivated by concerns over inflation expectations being unanchored to the downside and concern over the ability to adjust the Fed Funds rate ahead of another economic downturn. The debate will primarily be focused on the concept of "average inflation targeting" which is a policy whereby the Fed could aim for inflation above 2% in good times to make up for readings below 2% during recessions. Theoretically, this policy would 1) lower the odds of a rate hike thus keeping short rates lower for longer, 2) steepen the Treasury curve and 3) keep inflation expectations more stable and less susceptible to the disinflation/deflation problems currently faced by the BOJ and ECB. Longer term it would likely bias the Fed towards a dovish stance since history has shown it is clearly easier to tighten policy far enough to slow inflation but raising the inflation rate has proven to be much more difficult. This is evidenced by the Fed's recent inability to hit its 2% target for any sustained period over the past decade (above). We are likely to get more information around this inflation framework during the Chicago Fed's symposium in June when participants review the Fed's current "monetary policy strategy, tools and communication practices."

These discussions around the inflation framework have their place and have been mentioned in the past by former Chairs Yellen and Bernanke. However, the Fed is likely better served in trying to understand the drivers of inflation versus adjusting its long-standing policy framework and dealing with the unintended consequences. The TIPS market for one has not bought into the potential efficacy of this revised inflation framework as evidenced by the muted reaction across the breakeven curve around these headlines. In fact, the 10yr breakeven rate (implied inflation over the next 10 years) stood at 1.89% as of March 12 or 5 bps *lower* than the February month-end level. ■

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