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INSIGHT

MONTHLY COMMENTARY

U.S. Rates Update June 2019

MICHAEL Y. PAK, CFA | 9 JULY, 2019

The Fed remained on center stage throughout the month beginning with a conference hosted by the Chicago Fed on "Monetary Policy Strategy, Tools and Communication Practices." In his opening remarks Chairman Powell wasted no time in addressing the elephant in the room, namely the on-going trade dispute with China: "We are closely monitoring the implications of these developments for the U.S. economic outlook and, as always, we will act as appropriate to sustain the expansion, with a strong labor market and inflation near our symmetric 2% objective." After reassuring markets that the Fed was not asleep at the wheel, the focus shifted back to the scheduled agenda where the overriding tone was dovish with respect to monetary policy, inflation and the labor market. Various speakers from within and outside the Fed reminded participants that "unconventional policy works" although it is less effective than cutting the Fed Funds rate. Additionally, although the Fed ruled out raising the inflation target for now, it did state that the economy would be better off with a higher target and also underscored the direct and indirect benefits of running a hot labor market. Immediately after the conference and almost on cue, Vice Chairman Clarida reinforced the message by explicitly stating that the Fed would "put in place policies that not only achieve but sustain price stability and maximum employment, and we'll do that if we need to."

The FOMC meeting later in June reflected the same dovish tone from this conference as well as from various Fed officials' public comments leading up to the meeting. The Fed left its policy rate unchanged (target Fed Funds remains in the 2.25%-2.50% range), removed the word "patient" from its opening statement and marked down its projections for the neutral Fed Funds rate and inflation. Additionally, eight Fed officials saw rate cuts in 2019 with seven of those eight expecting two 25 basis point (bps) cuts this year. Digging into the Summary of Economic Projections (below) - a reduction in the projected longer run neutral Fed Funds rate from 2.8% to 2.5%, downward revisions to the PCE inflation forecast from 1.8% to 1.5%, and the emphasis on declining inflation expectations all point to a committee that thinks the current policy stance is too tight. The lowering of the estimate for the neutral Fed Funds rate is especially worth highlighting since for the past decade, the Fed has been arguing that monetary policy was accommodative and supportive of growth and inflation.

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Percent

Variable	Median[1] 2019	2020	2021	Longer Run	Central tendency[2] 2019	2020	2021	Longer Run	Range[3] 2019	2020	2021	Longer Run
Change in Real GDP	2.1	2.0	1.8	1.9	2.0–2.2	1.8–2.2	1.8–2.0	1.8–2.0	2.0–2.4	1.5–2.3	1.5–2.1	1.7–2.1
March Projection	2.1	1.9	1.8	1.9	1.9–2.2	1.8–2.0	1.7–2.0	1.8–2.0	1.6–2.4	1.7–2.2	1.5–2.2	1.7–2.2
Unemployment Rate	3.6	3.7	3.8	4.2	3.6–3.7	3.5–3.9	3.6–4.0	4.0–4.4	3.5–3.8	3.3–4.0	3.3–4.2	3.6–4.5
March Projection	3.7	3.8	3.9	4.3	3.6–3.8	3.6–3.9	3.7–4.1	4.1–4.5	3.5–4.0	3.4–4.1	3.4–4.2	4.0–4.6
PCE Inflation	1.5	1.9	2.0	2.0	1.5–1.6	1.9–2.0	2.0–2.1	2.0	1.4–1.7	1.8–2.1	1.9–2.2	2.0
March Projection	1.8	2.0	2.0	2.0	1.8–1.9	2.0–2.1	2.0–2.1	2.0	1.6–2.1	1.9–2.2	2.0–2.2	2.0
Core PCE Inflation[4]	1.8	1.9	2.0		1.7–1.8	1.9–2.0	2.0–2.1		1.4–1.8	1.8–2.1	1.8–2.2	
March Projection	2.0	2.0	2.0		1.9–2.0	2.0–2.1	2.0–2.1		1.8–2.2	1.8–2.2	1.9–2.2	
Memo: Projected Appropriate Policy Path												
Federal Funds Rate	2.4	2.1	2.4	2.5	1.9–2.4	1.9–2.4	1.9–2.6	2.5–3.0	1.9–2.6	1.9–3.1	1.9–3.1	2.4–3.3
March Projection	2.4	2.6	2.6	2.8	2.4–2.6	2.4–2.9	2.4–2.9	2.5–3.0	2.4–2.9	2.4–3.4	2.4–3.6	2.5–3.5

1. For each period, the median is the middle projection when the projections are arranged from lowest to highest. When the number of projections is even, the median is the average of the two middle projections.
2. The central tendency excludes the three highest and three lowest projections for each variable in each year.
3. The range for a variable in a given year includes all participants' projections, from lowest to highest, for that variable in that year.
4. Longer-run projections for core PCE inflation are not collected.

Source: Federal Reserve

It is also important to highlight that during the post-meeting press conference, Powell was very deliberate and appeared to go out of his way in stating that the committee's cautious stance on the outlook for the U.S. economy stemmed from more than just trade tensions with China. Powell asserted that it was important that monetary policy not overreact to short-term swings and sentiment which could risk adding "more uncertainty to the outlook." He noted that the committee was seeing weakness in a variety of indicators across manufacturing and trade which could be driven by a multitude of factors unrelated to trade.

On the heels of this dovish meeting which arguably delivered everything except an actual rate cut, the market quickly priced in a 25% chance of a 50bps cut by this July's meeting (odds were 90% of a single 25bps cut going into the June meeting) and four 25bps cuts by September 2020. The 2s/10s Treasury curve steepened 5bps immediately after the announcement and the 2yr Treasury rallied almost 17bps over the month. Even with this impressive rally in the front-end of the Treasury curve, 2yr swap spreads briefly traded negative during the month for the first time ever as demand for duration in 2yr swaps (and higher financing costs) temporarily outpaced the rally in the Treasury market. The 30yr Treasury underperformed only rallying 4bps as the market remains skeptical that even these aggressive cuts can generate inflation which was also evidenced by 30yr TIPS breakeven, which closed the month 7bps lower. It should be noted that the U.S. rates market was already in rally mode before the FOMC decision, driven by comments from the ECB president Mario Draghi at that monetary authority's annual policy forum. Draghi appeared to set a very low bar for an even more accommodative monetary policy stance going forward by stating that "additional stimulus will be required" if the economic outlook in the Eurozone does not improve. He went on to state that further cuts were part of the ECB tool kit, along with renewed asset purchases. Needless to say, Draghi's comments sparked a massive rate rally in the Eurozone. The 10yr Bund (German) broke below -.30% and a broad-based rally saw the 30yr OAT (French) rally 11bps to close under 1%. Fueled by this price action as well as recent rate cuts by central banks in Australia and New Zealand, the market value of bonds trading at negative yield hit a record $13 trillion to close the month. Lastly, the entire Swiss yield curve now trades at negative yields after its long end was dragged to the negative rate "party" by Draghi after sitting near zero to start the month.

So with the Fed stating that trade tensions were not directly a central focus, all eyes turn back to the economic data. In the U.S., a string of weaker data was released during June, in particular the Chicago PMI (Purchasing Managers Index) which fell into contractionary territory by printing at 49.7 vs 54.2, its lowest reading since February 2016 (the forward-looking New Orders index fell from 58.6 to 49.6). In isolation, this reading would not raise as much alarm, however, when combined with other regional

manufacturing surveys during the month, which showed declines across the nation, the data paint a disappointing picture of U.S. manufacturing and certainly have the attention of the Fed. The PMI picture globally was no better in June as the IHS Markit Global PMI index dipped to 49.8, its lowest reading since October 2012. The underlying details showed that the breadth of the slowdown had in fact widened with the number of countries reporting deterioration in manufacturing conditions rising vs the previous year.

Turning back to the U.S., we do however expect to get more clarity on the direction of monetary policy going into the July FOMC meeting from the releases of some first-tier data during the month which should reflect the removal, albeit temporary, of any immediate concern over trade. The broader risk markets do not appear to be pricing in a recession scenario so far and instead the total return performance on the month (S&P 500 +7.05%, HY +2.28%, IG credit +2.26%) in the face of 100bps of easing priced in by end of 2020 appears to signal the perception of a preemptive Fed likely to embark on insurance cuts. So with an imminent escalation of trade tensions with China off the table for now (G20 meeting between Trump and Xi resulted in no new tariffs on Chinese exports plus concessions on U.S. company business with Huawei), the evolution of economic data between now and the July FOMC meeting will be the market's focus. The old-fashioned data will now signal to the market if the Fed is likely to remain in risk management mode and deliver a 25bps cut (a reversal of December's hike) or possibly take a more aggressive approach (50bps cut) to provide as much initial stimulus as possible and avoid hitting the zero lower bound. ■

	5/31/19	6/30/19	Change
2yr Treasury	1.92	1.75	-0.17
5yr Treasury	1.91	1.77	-0.14
10yr Treasury	2.12	2.01	-0.12
30yr Treasury	2.57	2.53	-0.04
30yr TIPS Breakeven	1.83	1.76	-0.07
3mo Treasury Bill	2.34	2.09	-0.25
3mo LIBOR	2.50	2.32	-0.18
Fed Funds	2.40	2.40	0.00
SOFR	2.49	2.50	0.01
U.S. Dollar Index	97.75	96.13	-1.62
LIBOR/OIS	0.16	0.19	0.04

Source: Bloomberg

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