INSIGHT

MONTHLY COMMENTARY

U.S. Rates Update July 2019

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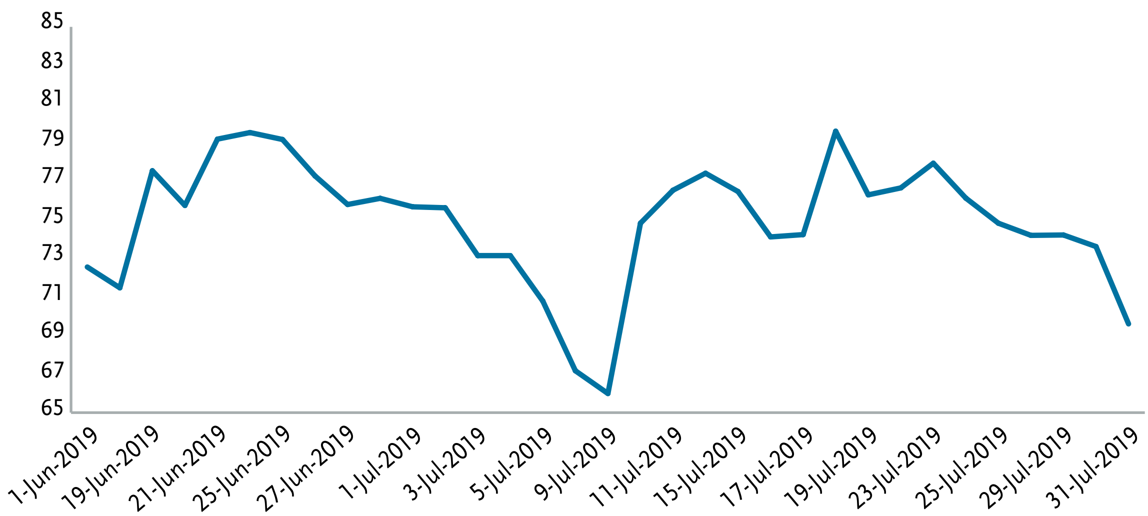
The Federal Open Market Committee (FOMC) cut its policy rate at the end of July for the first time since the onset of the financial crisis in 2008. While the 25 basis points (bps) cut had been fully priced into the market (along with a 13% chance of a 50 bps cut), the only mild surprise from the committee's statement was the announcement of an early end to the Fed's balance sheet run-off, which was pulled forward by two months into August. So, in the end, the first cut to the Fed Funds rate in 11 years mostly went off with little fanfare. However, it followed a somewhat tortured communications process. In the weeks leading up to the meeting a series of curious rumblings from central bank officials sparked episodic bouts of market volatility, whipsawing the Treasury and Fed Funds futures markets. This garbled central bank-speak throughout the month (which is summarized below) was capped off by Fed Chairman Powell's post-FOMC press conference on July 31, which further tripped up markets. The entire episode could best be summed up by the famous line from *Cool Hand Luke*, "What we've got here...is failure to communicate."

The month started off with Powell's semi-annual testimony before the House Financial Services Committee where he reiterated that uncertainties around trade tensions and global growth had "continued to weigh on the U.S. economic outlook" since the FOMC last met in June. Although he tempered that statement by noting that the baseline case remained for solid growth and strong labor markets, he kept circling back to concerns over muted inflation pressures and the increase in uncertainties over the past few months. So, despite relatively positive U.S. economic data since the June meeting and a pause in trade tensions with China, Powell's comments suggested that the Fed was maintaining its cautious stance and believed some cuts were still appropriate. He deftly evaded a question on whether a 25 bps or 50 bps cut was more likely in July and seemed almost dismissive of the recent economic data. In fact, when questioned if the solid June payroll report that had been released only a few days earlier altered the Fed's outlook at all, he flatly stated that it did not. As Powell's testimony appeared to cement expectations for a rate cut, the market reaction was swift. The 5s30s Treasury curve steepened 9 bps and front-end yields moved 8 bps lower. This price action was reinforced by the dovish June FOMC minutes released later that day, which echoed the sentiments of Powell's testimony.

Then, as we were moving toward the blackout period before the July FOMC meeting (when Fed officials would remain silent on policy), NY Fed President John Williams stunned the market by making some relatively specific and blunt comments around Fed policy options. He stated that in a scenario when rates were near the zero lower bound, you "don't keep your powder dry - that is, move more quickly to add monetary stimulus than you otherwise might." Spurred by these comments, the Fed Funds market immediately priced in a 50% chance of a 50 bps cut, 2 year Treasuries rallied 8 bps and the 5s30s Treasury curve steepened 5 bps. Adding fuel to the fire was an unscheduled appearance by Fed Vice-Chair Clarida that same day when he basically echoed similar sentiments around the benefits of aggressive preemptive easing. Needless to say, the timing of these comments by two of the Fed's top officials had conspiracy theorists surmising it was a last-ditch coordinated effort by the Fed to prep the market for a 50 bps cut before its blackout period.

5s30s Treasury Curve (bps) Since June FOMC



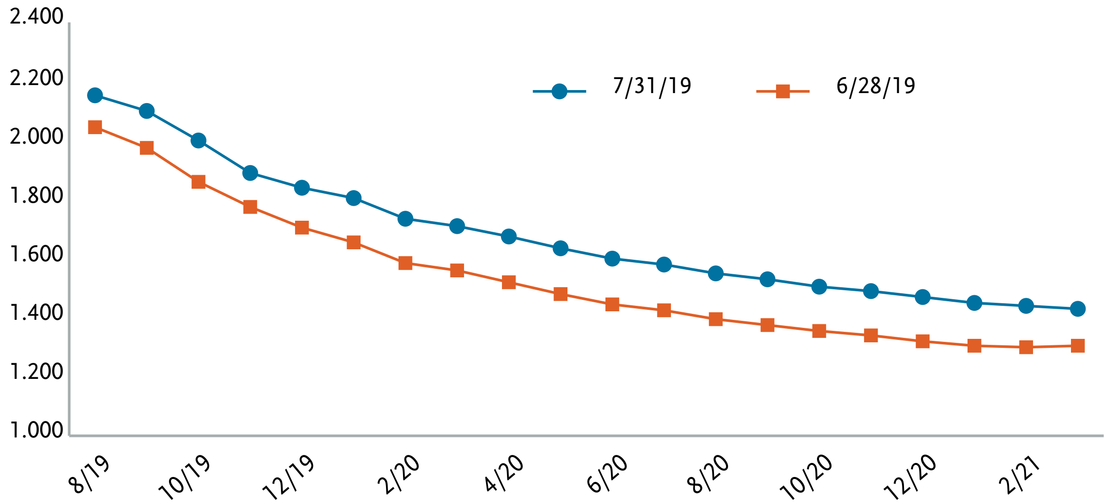
Source: Bloomberg

But then after the market close, and in an unprecedented move, the NY Fed released a statement essentially walking back its president's comments. The release stated that Williams' speech was not about "potential policy actions at the upcoming FOMC meeting" but rather just an observation around past academic research. On the heels of this head-scratching sequence of events, the market eventually reverted back to pricing in a single 25 bps cut in September. However, the admittedly clumsy public communication episode suggested that the debate over the path of policy within the Fed was real and perhaps the committee was not fully united heading into its meeting.

Not to be outdone, European Central Bank (ECB) President Draghi's comments after that monetary authority's policy meeting on July 25 also seemed incongruent with the tone of the bank's press release. Although the ECB left rates unchanged, as expected, at its July meeting, it basically re-wrote the entire press release and appeared to be setting up the market for a package of policy easing in September. However, Draghi's post-meeting Q&A session came across as more hawkish than the statement. He commented that the bank had "no discussion about cutting rates today" but more importantly saw "risk of recession as pretty low." The apparent about-face by Draghi whipsawed the German bond market with its benchmark 10 year selling off as much as 9 bps intra-day to touch a "high" yield of -.34%. However, at the end of the day, the path in the Eurozone still appears to be towards one of rate cuts this September joining a growing list of central banks (South Korea, Indonesia and Turkey) that have recently eased, citing deterioration in both GDP growth and the inflation outlook.

As noted, the FOMC delivered the 25 bps cut that the market had expected, moving the Fed Funds target range down to 2.25%-2.00%, with two committee members dissenting. Additionally, the end of the balance sheet run off was moved forward to August 1 from October 1. The Boston Fed's Rosengren and Kansas City Fed's George preferred to hold rates steady. Rosengren eventually released a statement explaining he dissented because he did not see a "compelling case for additional monetary accommodation at this time." Dissents aside, the FOMC press release suggested that more easing was on the table, noting "as the Committee contemplates the future path of the target range for the Federal Funds rate, it will continue to monitor the implications of incoming information for the economic outlook and will act as appropriate to sustain the expansion."

Fed Funds Futures



Source: Bloomberg

At the post-FOMC meeting press conference, Powell commented that the July rate cut was "not necessarily" the start of a prolonged rate cutting cycle and that the action today was a "mid-cycle adjustment." This last phrase jolted markets as it implied the Fed would not deliver as many cuts as were priced into the market. Powell later tempered his message by stating that he didn't think there would be "only one rate cut in this adjustment."

On the back of these mixed messages, the 5s30s curve flattened almost 10 bps at the tights, the 2 year sold off an amazing 15 bps at one point, and September Fed Funds priced out over half a cut. Although Treasuries finished the month off these extreme levels, the damage to Fed credibility was done and the market was back to pricing in a Fed that is behind the curve and on the brink of a policy error. Until the Fed's message is more clearly and decisively communicated, we can likely expect the Treasury curve to continue to invert, spread product to underperform, and recession risks to stay elevated.

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	6/30/2019	7/31/2019	Change
2 yr Treasury	1.75	1.87	0.12
5 yr Treasury	1.77	1.87	0.06
10 yr Treasury	2.01	2.01	0.01
30 yr Treasury	2.53	2.53	-0.00
10 yr TIPS Breakeven	1.76	1.79	0.03
3mo Treasury Bill	2.09	2.07	-0.02
3mo LIBOR	2.32	2.27	-0.05
Fed Funds	2.40	2.14	-0.26
SOFR	2.50	2.55	0.05
U.S. Dollar Index	96.13	98.52	2.39
LIBOR/OIS	0.19	0.21	0.02

Source: Bloomberg