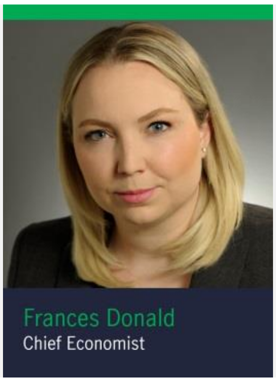
Manulife Asset Management

Market Note:
A Fed July interest-rate cut isn't a done deal

20 June 2019



On 19 June, The US Federal Reserve (Fed) kept interest rates unchanged, as expected, but held the door open for a rate cut in the coming months if the economic outlook for the US deteriorates. Frances Donald, Chief Economist and Head of Macroeconomic Strategy, believes that an interest-rate cut in July isn't a done deal and investors should keep their eyes on September. She also identifies the key takeaways from Wednesday's decision.

Wednesday's communication from the Fed is consistent with our base case expectation of two rate cuts in the second half of 2019, beginning in September. It also adds to our conviction that the Fed is primarily concerned that ongoing uncertainty is damaging confidence and, by extension, business investment. It's also likely that the Fed's hoping to compile a dossier pointing to economic weakness so that it can credibly cut rates, but we don't think enough weak economic data prints will present themselves in time for a July cut.

Overall, we feel the information we received from the Fed on Wednesday was more hawkish than the market reaction (or news headlines) implied.

How Wednesday's Fed meeting influenced our market views

- We remain upbeat about global equities: Proactive rate cuts (i.e., early) have historically benefited the equities space more as opposed to reactive (i.e., late) rate cuts. At this point, we're still in the "proactive" end of the spectrum.
- We continue to believe that the US dollar will remain range-bound, with upside potential. While the Fed has made a dovish pivot, it's largely priced into the US market[1] and we see substantial scope for global central banks, particularly the European Central Bank and the People's Bank of China, to engage in more aggressive easing activity in the next month—developments that could offset US dollar weakness.
- We believe the Fed will have trouble delivering more rate cuts than what the fixed-income market has already priced in. However, should data deteriorate in the coming weeks, we think there's scope for the Fed to act sooner and take bolder actions than what's currently expected.

Our primary takeaways[1]

1 The Fed still believes the US economy is still sound, but is worried about risks created by ongoing uncertainty

Fed Chair Jerome Powell repeatedly noted that the outlook for the US economy remains sound, highlighting that wages are rising, jobs are plentiful, and consumer confidence is high[2]. The Fed's concerns are related to what he refers to as two specific crosscurrents: trade tensions and global growth. In our view, these are one and the same. The deterioration in global trade activity has been substantially exacerbated by trade tensions and its affiliated uncertainty.

Interestingly, when Chair Powell was asked about whether a US-China trade deal would erase his concerns at Wednesday's press conference, he highlighted that he cared more about the economy's response to it. We take that to mean that the Fed is far more focused on whether economic activity is deteriorating because of policy uncertainty than the content of the policies. That implies the Fed will be hyper data dependent in the coming months, even if that phrase seems to have exited their more recent communication. We should be prepared for substantial volatility around key economic releases over the next several months.

2 The case for a rate cut in July isn't clear cut

At the press conference, Chair Powell made several references to the Fed's need to "see more" to get a sense of how risks are weighing on US economic outlook—are they a blip in the road or a sign of more sustained weakness? Critically, he referenced the weak May jobs report (in which only 75,000 jobs were added during the month) and noted that the Fed typically requires three to six months' worth of data to get a sense of the overall trend.

When asked if the Fed felt there were risks associated with cutting rates too early, Chair Powell suggested they didn't feel the case for cuts was urgent. He also noted that there hadn't been any support—save for one individual—for cutting rates at the June meeting. In our view, barring major developments, it's difficult to see how the majority of the Fed's voting members could swing from wanting to keep rates on hold in June to supporting a rate cut in the space of six weeks. This has strengthened our belief that the Fed won't have enough conviction that the US economy is truly in need of stimulus until the September meeting.

3 Market pricing remains disconnected from the Fed's outlook

Upon closer examination, we thought the Fed's dot plot[3] held a few important nuggets:

- The median dot plot is unchanged for 2019 as eight out of the seventeen officials expect to see rate cuts this year, another eight think rates should stay on hold during the period while one believes a rate hike would be appropriate. The median dot for 2020, however, indicated a consensus call for one interest-rate cut. This is completely inconsistent with what the markets have priced in—more than three interest cuts in the next 12 months[4].
- Seven of the eight Fed officials who believe rate cuts would be appropriate this year suggested *two* cuts instead of one. In other words, if the Fed were to cut rates, it's unlikely to stop at one. An easing cycle, per this signal, is likely to comprise at least two interest-rate cuts.

[1] From the FOMC statement, forecasts, dot plot and press conference.
[2] Source: Bloomberg, as of 19 June 2019.
[3] Source: FOMC Press Conference, 19 June 2019.
[4] Source: Projections, US Federal Reserve, 19 June 2019.

- We also noted that the dot plot shows rate cuts are expected to be unwound by 2021, suggesting the Fed isn't expecting a deep recession, but clearly sees the need for some near-term stabilisation. For those of us with longer-term forecasts, this has key implications.
- Chair Powell highlighted that Fed officials who didn't think rate cuts are needed this year noted that the case for cuts had strengthened: We believe this implies the dot plot is more dovish than it initially appears.

4 The Fed's economic projections don't reflect the dot plot

We were surprised by how little the Fed's economic projections[3] had changed. Indeed, GDP and unemployment were revised higher over the forecast period, long-run estimates of growth and unemployment were unchanged, and only core inflation was revised downward (mildly). If all we had received from the Fed on Wednesday were its projections, I would have believed this central bank was neutral to *hawkish*.

More volatility

Chair Powell's dovish tone, accompanied by a little-changed economic forecast, create a challenge for economists and markets: What is the Fed's true decision-making function? Is it in flux? The inconsistency, in my own view, will create more volatility in the market and could risk longer-term credibility issues for the Fed. For now, however, Chair Powell can get away with claiming that the Fed's views are consistent with its base case expectation of a healthy US economy, albeit one that faces significant downside risks.

Disclaimer