Market Bulletin

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Fed rate cut: What does it mean for investors?

In brief

- At its July meeting, the U.S Federal Reserve (the Fed) cut rates for the first time since December 2008. Officially, the Fed are cutting over fears about long-term inflation. Unofficially, political pressure and trade tensions may have pushed them into a rate cut.
- The market is expecting three more rate cuts over the next 12-months but the Fed will be resistant to delivering this for fear of inflating asset bubbles late in the cycle. Trade tensions, however, may be the deciding factor in pushing the Fed to reduce rates further.
- Rate cutting cycles have historically steepened the yield curve. While yields may be low, investors can still find value in long-dated bonds as a hedge against equity market volatility.

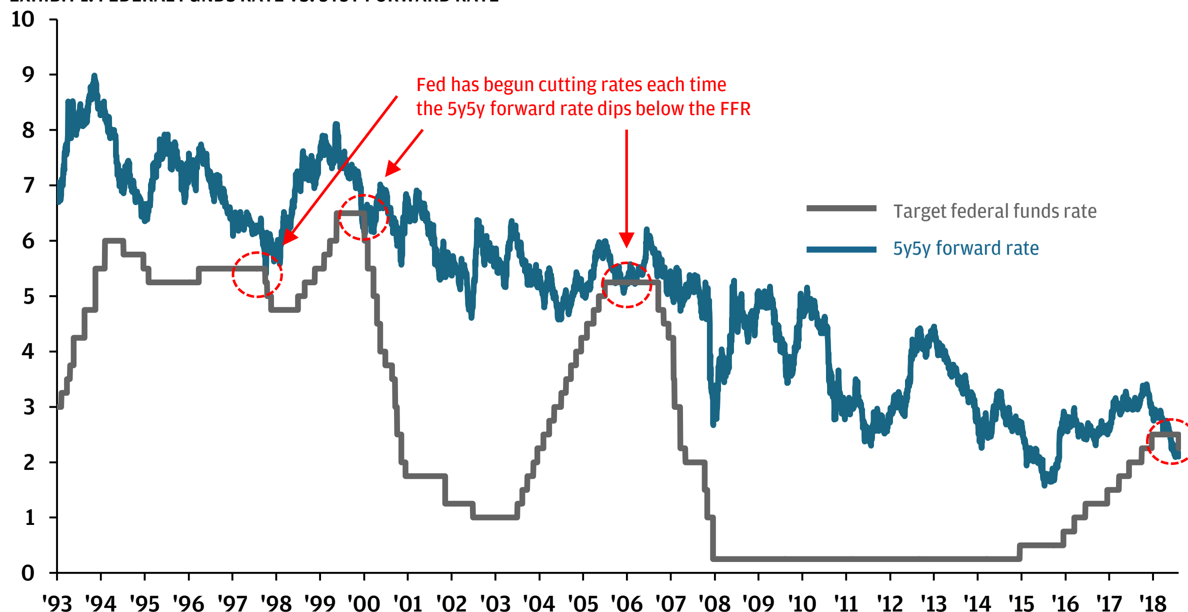
Why is the Fed cutting interest rates?

The Fed aims to achieve full employment and inflation at 2%. With the economic expansion entering a record 11th year, unemployment at a multi-decade low and inflation averaging 1.60%[1] over the course of this expansion, the Fed looks to have done a reasonable job of steering the ship. So why are the Fed cutting rates now?

Officially, the Fed are citing inflation as its primary reason for cutting rates. Not necessarily because of where inflation is today, but concerns over where inflation may be heading. Indeed, **Exhibit 1** highlights that long-term inflation expectations[2] have dipped recently and may warrant a rate cut. Historically, a convergence between interest rates and long-term inflation expectations is a warning signal that short-term monetary policy is too tight relative to long-term inflation expectations and a cut is necessary.

[1] Measured by the core personal consumption deflator, the Fed's preferred inflation metric.
[2] Measured by the 5-year, 5-year forward rate. Essentially what the market is expecting average inflation to be for five years beginning in five years' time. Due to its long-term nature it can be used as a proxy for investor's long-term inflation expectation.

EXHIBIT 1: FEDERAL FUNDS RATE VS. 5Y5Y FORWARD RATE



Source: Bloomberg, J.P. Morgan Asset Management. Data are as of July 31, 2019.

Unofficially, however, there are other factors at play. Political pressure, trade tensions and economic weakness globally, are just a few other issues that may also justify the recent change in stance. Given the Fed is reluctant to comment on these politically-charged topics, it may instead be using falling long-term inflation expectations as a convenient scapegoat for cutting rates. Regardless, the Fed has now entered into a rate cutting cycle.

What will the Fed do next?

The Fed is keen to present its latest move as an "insurance" rate cut, necessary to lengthen the expansion but not the start of a prolonged easing cycle. Historically, this is a difficult balance to achieve. Over the last 30 years, in 81% of months that the Fed cuts rates once, it was followed with a subsequent cut within six months. In short, when you start eating a delicious cookie, it can be very hard to not grab a second.

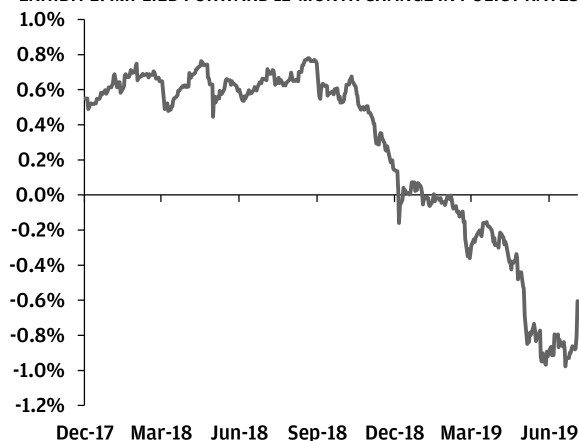
Controlling investors' expectations is the key to this balancing act, of which the Fed still have some work to do. In the July press conference, Jerome Powell stated that the committee expects rate cuts to be a "mid-cycle adjustment to policy" and does not anticipate a prolonged cutting cycle. Moreover, in its latest quarterly forecasts, no Fed official predicted more than one more cut by the end of 2020. Yet, while markets did reprice to suggest less aggressive easing, as **Exhibit 2** highlights, it still expects roughly two and a half more cuts in the next 12-months. The Fed is wary of meeting such lofty expectations given it has seen this story play out. In 1998, three 25bps rate cuts in three months helped inflate the tech bubble. With U.S equity markets currently sitting at record highs, the Fed is uneasy with inflating another asset bubble and therefore pushed back on current market expectations in their latest press conference. Stabilization or even improvement in economic data both in the U.S and abroad would also give the Fed some flexibility and allow it to justify putting the lid back on the cookie jar.

However, trade tensions remain the wild card. An escalation in trade tensions would inflict further

damage on an already slowing global economy likely forcing the Fed into a more prolonged easing cycle. While trade tensions have simmered down since the G-20 summit in June, a significant resolution on trade remains elusive.

In summary, our baseline is that the Fed will cut rates once more this year, potentially in September. The Fed will then attempt to use any improvement in economic data to walk back expectations of further easing through the end of this year and into 2020 however, trade tensions remain the deciding factor.

EXHIBIT 2: IMPLIED FORWARD 12-MONTH CHANGE IN POLICY RATES



Source Bloomberg, J.P. Morgan Asset Management. Data are as of July 31, 2019.

What does it all mean?

The path ahead for bond yields remains uncertain. Rate cuts are likely to drag down short-dated bonds and potentially steepen the yield curve. The yield on the 3-month T-bill has already fallen from 2.42% at the start of 2019 to 2.06%, as investors have begun to factor in Fed easing.

Meanwhile, long-dated bond yields look to be caught in a tug-of-war. Rising budget deficits and any resolution in trade tensions could justify higher yields on the 10-year going forward. Meanwhile, international investors continue to buy U.S Treasuries. The U.S 10-year may yield just 2.02%, but that is higher than 88% of other developed market government bonds. With the ECB and other central banks hinting at further steps to loosen monetary policy, it is likely the $12 trillion of negative yielding global debt will grow, putting downwards pressure on U.S yields.

Although the yield on long-dated U.S Treasuries has fallen sharply they still play an important role in hedging equity market volatility. Should the U.S 10-year yield fall from 2% back to its record low level of 1.36%, it would generate a total return of approximately 8.0% over the course of a year. The U.S economy has entered a record 11th year of growth and while cycles do not die of old age they do become more vulnerable to external shocks. In a world of slowing global growth, rising geopolitical tensions and trade fears, long-dated bond yields can still provide a valuable hedge against financial market volatility.

Investment Implications

A fall in long-term inflation expectations looks to be the official reason for justifying a rate cut at this stage in the cycle. However, unofficial factors including political pressure and trade concerns may have also forced the Fed into action.

The Fed will attempt to deliver just two rate cuts however, the market is pricing in a prolonged rate cutting cycle. The deciding factor is likely to be how trade talks evolve and the damage it does to the global economy.

Investors may be reluctant to buy the U.S 10-year at these low yield levels however, long-dated bond are still a valuable hedge against late-cycle volatility.

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