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A DOVISH FED THAT COULD BECOME EVEN MORE DOVISH

INSURANCE RATE CUTS POSSIBLE IN COMING MONTHS AS TRADE TENSION ESCALATES

Authors

THOMAS COSTERG
tcosterg@pictet.com

LAURÉLINE CHATELAIN
lchatelain@pictet.com

SUMMARY

- We now believe that the Federal Reserve (Fed) could deliver two 'insurance' rate cuts of 25bps in coming months (up to now, we expected rates to be on hold in 2019-2020).
- We see three drivers that could dictate the exact timing of these cuts: 1) a continuation of President Trump's pro-tariff stance (with a risk of dampening business sentiment and therefore investment); 2) confirmation in the data in coming months that business investment is indeed slowing; and 3) broader financial conditions, including the crucial role of inflation expectations.
- Importantly, we think the Fed could overlook a mild tariff-induced inflationary boost in the very near term, as it focuses more on the weakening medium-term growth outlook.
- We believe the conditions for cutting could be met in Q4 2019. If so, another cut could come in Q1 2020.
- These rate cuts would be the continuation of the dovish regime shift at the Fed since December 2018, when it abruptly abandoned plans to hike rates, and in early 2019, when it stopped its plans to shrink its balance sheet.
- They would also fit within our view of a broader Fed regime of 'debt dominance' with the Fed particularly concerned about financial conditions due to high corporate debt in the system. The other characteristic of this regime is the Fed's very pro-active business cycle management as it is fundamentally afraid of a recession and seeks to extend the business cycle (including by providing more accommodation).
- The June Fed meeting could pave the way for subtle changes in rhetoric, opening the door for cuts later on. In the very near term, the fallout from the G20 summit in Osaka at the end of June could be pivotal.
- Our revised Fed rate scenario means we are again revising down our central year-end forecasts for the 10-year US Treasury yield from 2.8% to 2.5%. We remain neutral on US Treasuries given the comparatively higher yields they offer and the low risk of a sharp rise in yields in the coming months.

Fed regime: Perpetual accommodation in a world of high corporate debt

As a backdrop, our Fed view is that we are in a monetary regime of 'debt dominance' as the Fed's role turns increasingly to achieving a 'soft landing' for US corporate debt, which has boomed in recent years. This means keeping financial conditions accommodative for firms, and in particularly maintaining a lid on their borrowing costs. Our big picture view is that monetary accommodation is likely to remain in place for some time given the amount of debt in the system.

This view also helps explain the sharp dovish turn seen in December-January, when the Fed showed outsized sensitivity to market volatility – and the sharp tightening of market financial conditions – even though the US economy has been doing fine.

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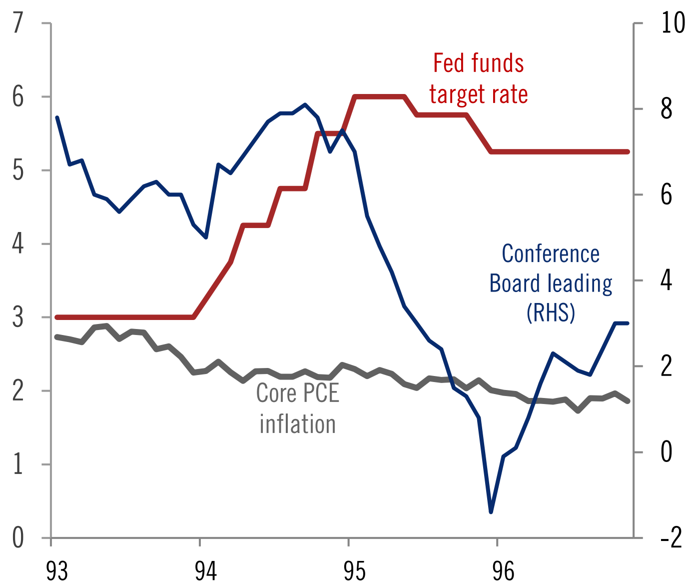
In addition, the Fed is intent on prolonging the business cycle, as it is fundamentally worried about a recession. This is related to the debt dominance regime mentioned above: the Fed is worried that tighter credit conditions could start to crimp corporate margins, which is usually how recessions start (ie. through a combination of higher labour and financing costs).

A continuation of the 2019 dovish shift

After a period of 'auto-pilot' rates hiking (the Fed hiked rates once per quarter between Q4-16 and Q4-18, with a short pause in Q3-17), which brought the federal funds target rate to 2.25%-2.50%, the Fed unleashed a torrent of dovishness, with the highlight being Jerome Powell's speech at the American Economic Association meeting in early January, when he signalled an abrupt end to earlier plans to shrink the balance sheet as he underscored that he "listens to markets".

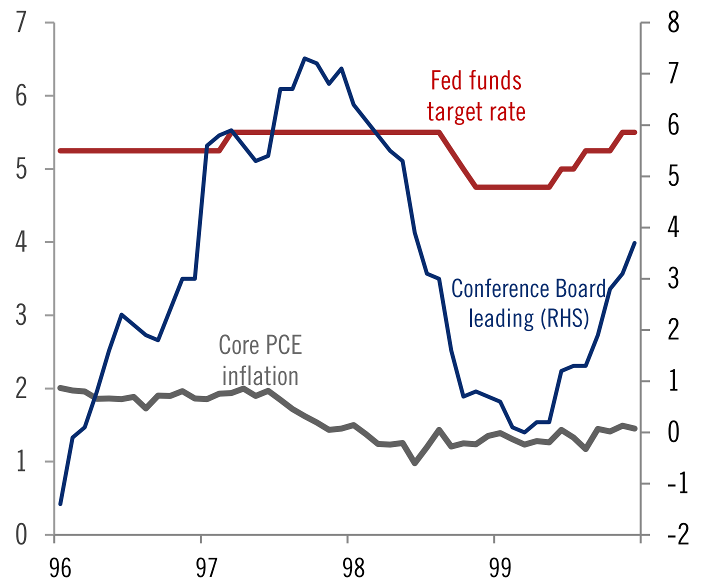
This dovish shift confirms our view of the regime now in place at the Fed, and shows how its policy reaction function prioritises financial conditions, particularly for US firms. It also reveals anxiety among Fed members about a recession, which it is trying to prevent at all costs. Importantly, the current regime explains why the Fed could be cutting rates despite a multi-decade low in unemployment.

CHART 1: INSURANCE RATE CUT: **1995** CASE STUDY



Source: PWM - AA&MR, Bloomberg

CHART 2: INSURANCE RATE CUT: **1998** CASE STUDY



Source: PWM - AA&MR, Bloomberg

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Three criteria to cut rates

Given that the Fed's recent dovishness confirms our belief that the Fed is particularly sensitive to the business cycle, we believe that the Fed could cut rates for 'insurance' purposes, with the aim to sustain business sentiment in an uncertain trade environment.

In other words, the Fed could be even more pre-emptive than usual, and could cut rates even if, as we believe, a recession is not around the corner. This would not be the first time such 'insurance' cuts happen: one can find echoes of them in rate cuts of 1995 and 1998. We believe the three criteria that could ultimately determine the timing for the first cut are:

1) President Trump prolonging his pro-tariff stance.

Trump has recently announced an increase in the tariff rate on roughly half of Chinese imports from 10% to 25% and threatened a 5% tariff on imports from Mexico (which could rapidly rise up to 25%), cementing the view that President Trump is indeed a self-proclaimed "Tariff Man". (He recently also wrote that tariff is a "beautiful word").

Most Fed members, who had tended to minimise trade tensions or expected them to fade, may be forced to rethink their position (and become even more dovish). But the Fed may want to wait for more data on the impact of trade tensions on firms, including the latest tariff increase on China's imports, before it moves to ease policy again.

2) Confirmation in the data of a slowdown in business investment.

More than the tariffs, we think that it is doubts about the direction of travel in US trade policy that could start to undermine business investment. This comes at a strenuous time as 2019 is seeing the 'animal spirits' unleashed by the end-2017 corporate tax cuts start to fade. The Conference Board Leading Economic Index, for instance, is now pointing down after peaking in September 2018.

3) Broader financial conditions, including the crucial role of inflation expectations

The Fed is putting particular emphasis on financial conditions, as shown in its dovish turn in December-January, and it could remain very sensitive to how markets evolve in the coming weeks.

A particular focus of late has been on market-based inflation expectations, which have dropped sharply in recent weeks. Taken in tandem with the undershoot in actual core PCE inflation (April's core PCE inflation remained soft at 1.6% y-o-y), this has led to some anxiety among Fed members that its 2% inflation target is at risk in the medium term, especially given the persistent 'miss' of inflation since the financial crisis.

These inflation expectations matter a lot since the Fed is permeated by neo-Keynesian theory, in which expectations play a crucial role in understanding the formation of actual inflation. This focus on inflation expectations also explains why the Fed could look through a temporary boost in inflation over the summer stemming from trade tariffs.

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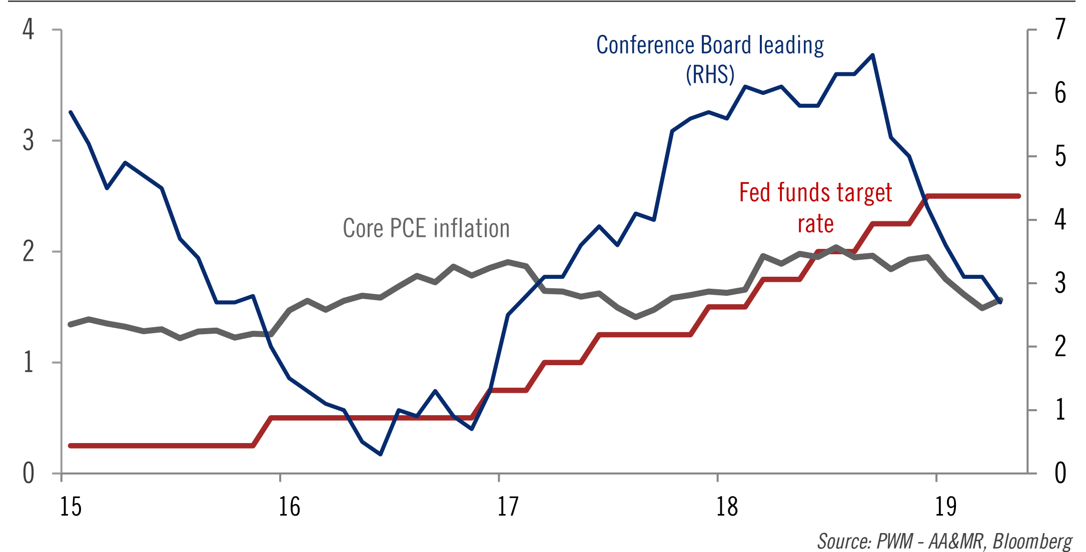
CHART 3: ECONOMIC MOMENTUM HAS WEAKENED OF LATE, WHILE CORE INFLATION HAS UNDERWHELMED



Source: PWM - AA&MR, Bloomberg

4) Additional considerations: Some remorse about 2018 tightening

Other factors playing a role in a potential rate cut in the coming months are:

- **Some remorse inside the Fed about the auto-pilot tightening that led to four rate hikes in 2018**, and the feeling it may have been overconfident about the US economy, including about a continuation of last year's investment boom and about the future path of inflation.
- **Yield curve inversion**. The Fed has been paying attention to the yield curve of late. Some dovish officials have shown uneasiness about the recent inversion in some segments of the curve, which they believe could foretell a recession, while others see in it a signal that the theoretical neutral policy rate is lower than was thought (inducing a need 'recalibrate' policy to avoid overtightening). This echoes the remorse above as the Fed could have been too confident about an increase in the theoretical neutral rate.
- Vagaries in **oil prices**. The escalation in trade tensions has been accompanied by lower global oil prices lately. As well as denting inflation, a prolonged drop in prices could also constitute a sword of Damocles over the important domestic energy sector, which has played an outsized role in powering the US economy in recent years. How oil prices behave could be especially instrumental in Fed policy making.

June might be too early for a rate cut

The next Fed meeting will be on 18-19 June, when new economic forecasts and new 'dots' (indications of how Fed members expect rates to move) will be released. We believe it might be too early to expect a rate cut then. We believe the Fed is more likely to wait for more clarity on US trade policy (the G20 Osaka meeting at end June will be important)

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and on business investment *(see point 2 above)*. Q2 GDP growth data – and the split between investment and consumption – released by end July, could also be important for Fed policy making.

Our team's view is that the US will ultimately impose a 10% tariff on the remainder of China's imports not already subject to tariffs within the next year. Such a move could be an important ingredient in the Fed's decision to provide 'insurance'.

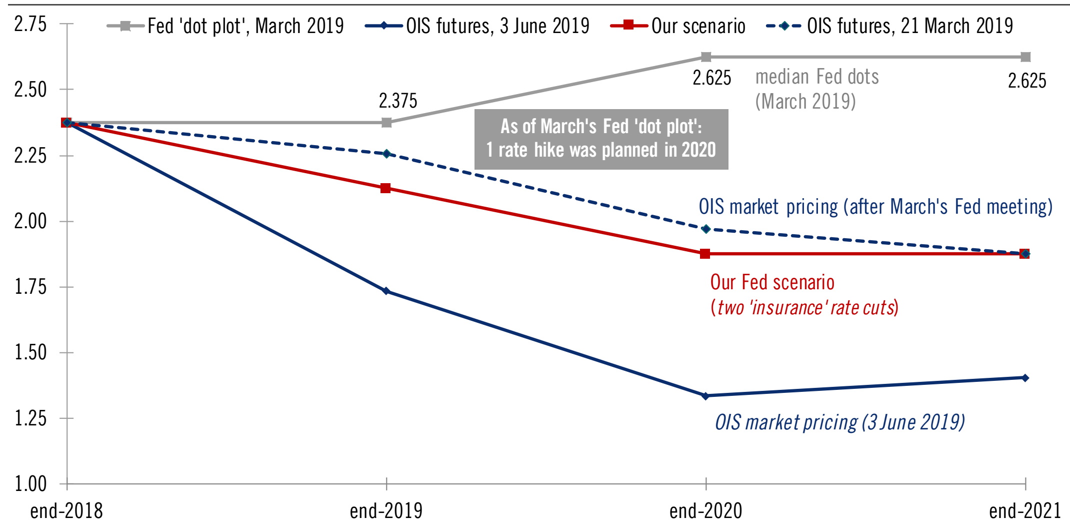
The Trump factor

Interestingly, Trump has intensified pressure on the Fed at the same time as he has escalated tension with China. In a tweet on 14 May, Trump wrote "China will be pumping money into their system and probably reducing interest rates, as always, in order to make up for the business they are, and will be, losing. If the Federal Reserve ever did a "match", it would be game over, we win!"

The Fed has been keen to show its independence from the White House. Some dovish members have recently framed the possibility of rate cuts in terms of low inflation, while consciously ignoring Trump's push for them to ease policy. Although cynics might view Trump's decision to raise tariffs as a way for him to get the Fed to eventually cut rates, low inflation and low inflation expectations are justification enough.

Importantly, the Fed will want to avoid being seen as interfering in the coming presidential campaign. The holding of the first state primaries in early 2020 could push the Fed toward a December 2019 move.

CHART 4: MARKETS EXPECT AN EVEN BIGGER AMOUNT OF ACCOMODATION IN COMING MONTHS



Source: Pictet WM-AA&MR, Bloomberg.

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Rates – From hiking to cutting means lower Treasury yields

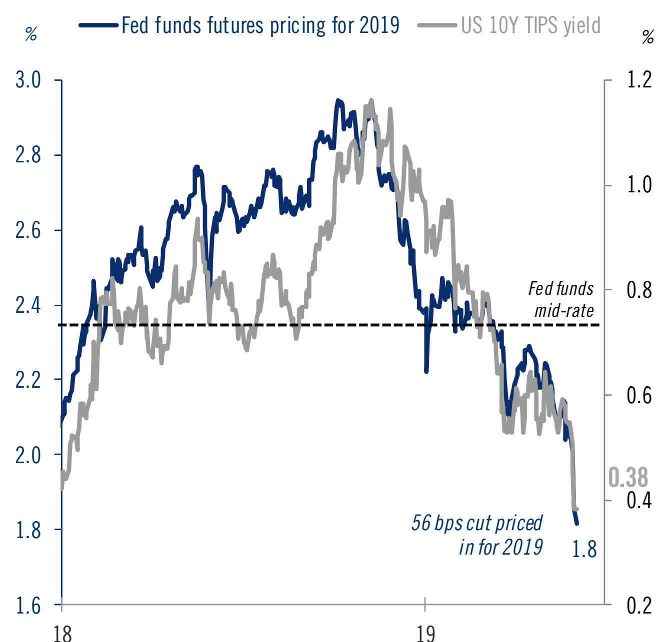
To take account of our new expectations regarding the Fed's policy path, we are again revising downward our central year-end forecasts for the 10-year US Treasury from 2.8% to 2.5% (*see Chart 5*).

Given rising global uncertainties and flaccid macroeconomic momentum, we see limited upside for the 10-year yield in the coming months, unless trade tensions unexpectedly fade. Yet market participants continue to price in more Fed's rate cuts than we expect (more than two compared with one in our scenario for this year), contributing to the spectacular fall in the 10-year Treasury yield last week (*see Chart 6*).

CHART 5: US 10-YEAR TREASURY YIELD BREAKDOWN

Source: PWM - AA&MR, Bloomberg, 31.05.2019

CHART 6: US 10-YEAR TIP AND FED FUNDS EXPECTATIONS



Source: PWM - AA&MR, Bloomberg, 31.05.2019

In the past, when the Fed has used the fed funds rate as a policy tool (i.e. most of the time, with the exception of 2009-2015), the 10-year Treasury yield, through the TIPS (Treasury Inflation-Protected Securities) yield, has been very sensitive to market expectations for the future path of the fed funds rate. This observation is corroborated by a model that breaks down the 10-year yield between the term premium (the premium required by investors to hold longer-term bonds) and policy rate expectations.

From explaining roughly half of the 10-year yield at the end of 2015, our analysis suggests that rate expectations accounted for more than 90% of the same yield at the end of May (*see Chart 7*). **Thus, the outlook for Fed policy will remain key in determining the direction of the 10-year yield. Given the current uncertainties, we believe market participants will continue to expect more rate cuts than us, meaning the yield should hover around 2.0% until the end of summer.**

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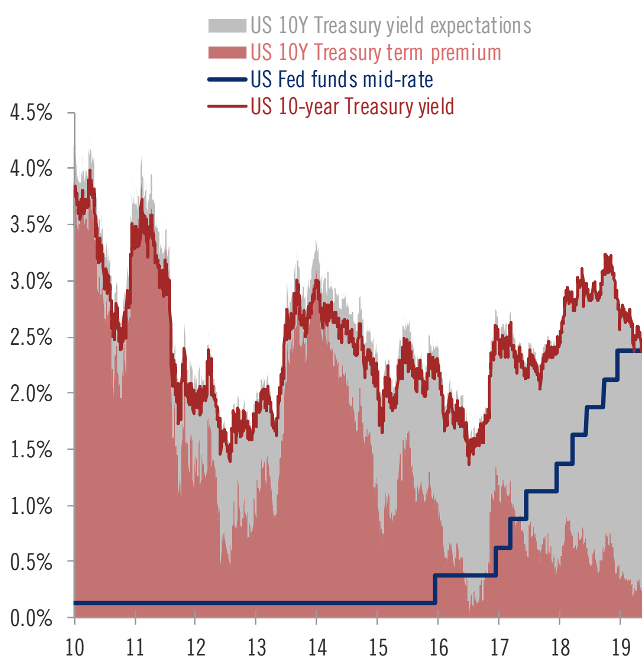
The recent fall in the oil price and, more importantly, three consecutive low prints for core PCE in the US contributed to push down long-term market expectations for inflation (with the 10-year Treasury inflation breakeven yield falling to 1.7% on May 31, *see Chart 8*). **But a rebound in core inflation in the US later this year, along with the signalling of upcoming 'insurance' rate cuts by the Fed could lift current inflation expectations.** Hence, we expect the 10-year inflation breakeven yield to rise towards 2.0% in H2, pushing the 10-year Treasury yield higher again.

CHART 7: US 10-YEAR TREASURY YIELD PREMIUMS



Source: PWM - AA&MR, Factset, 22.05.2019

CHART 8: US 10-YEAR TREASURY YIELD AND US CORE PCE

Source: PWM - AA&MR, Factset, 31.05.2019

However, should we see a more pronounced economic slowdown in the US and globally due to increasing trade tensions, the 10-year US Treasury yield could fall below 2.0% by year-end, as the aforementioned revival in inflation expectations could be counter-balanced by lower oil prices. At this stage, this remains our negative scenario (40% probability).

We remain neutral on US Treasuries given the comparatively higher yields they offer and the low risk of a sharp rise in yields in the coming months.

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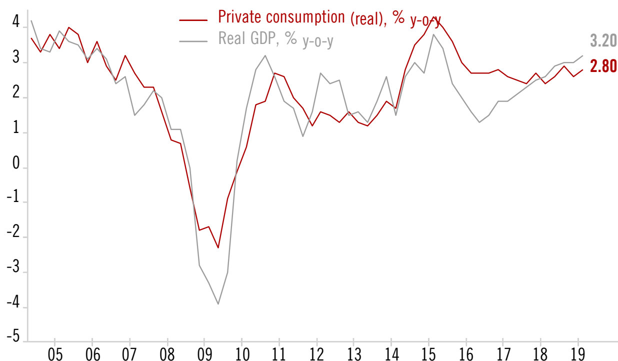
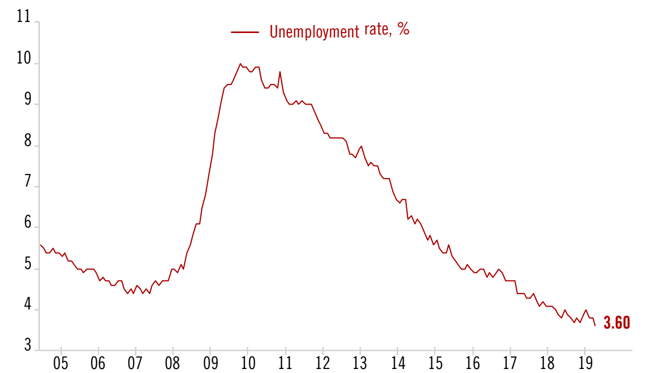
REAL GDP AND PRIVATE CONSUMPTION GROWTH, % Y-O-Y



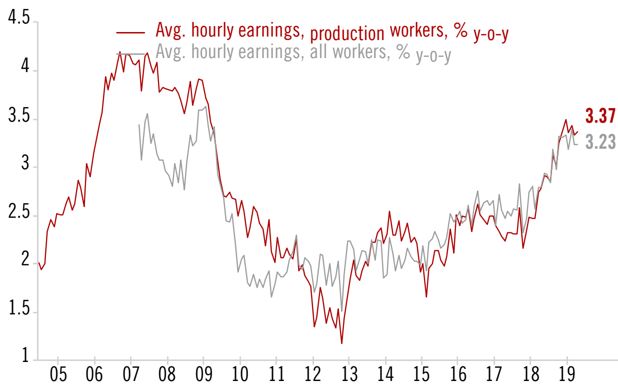
Source: Pictet WM – AA&MR, Factset

UNEMPLOYMENT RATE, %



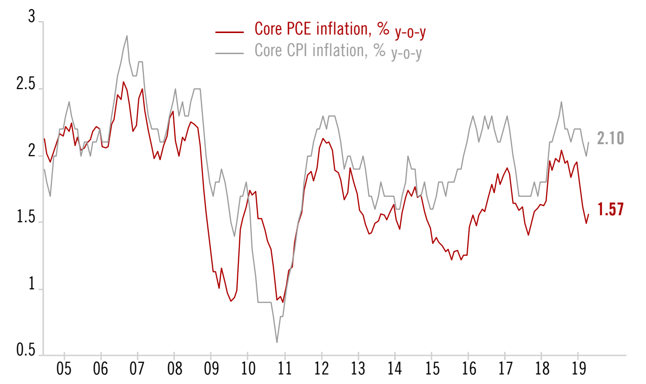
Source: Pictet WM – AA&MR, Factset

AVERAGE HOURLY EARNINGS (WAGE GROWTH), % Y-O-Y



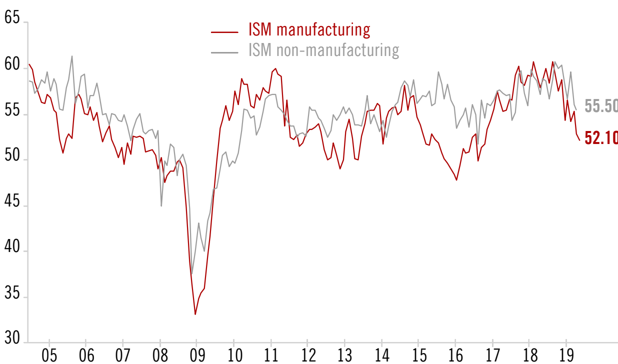
Source: Pictet WM – AA&MR, Factset

CORE INFLATION (PCE AND CPI), % Y-O-Y



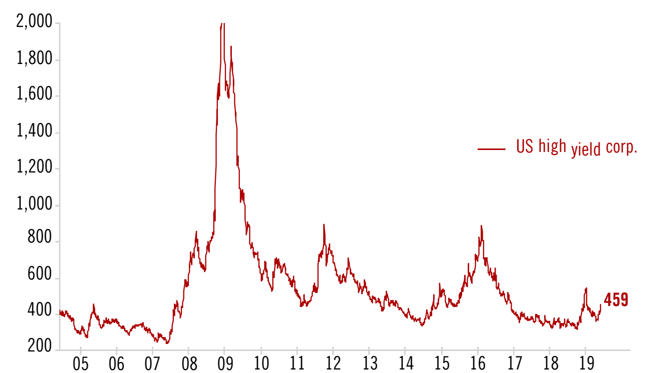
Source: Pictet WM – AA&MR, Factset

ISM BUSINESS SURVEYS



Source: Pictet WM – AA&MR, Factset

HIGH-YIELD CORPORATE BOND SPREAD, BASIS POINTS



Source: Pictet WM – AA&MR, Factset

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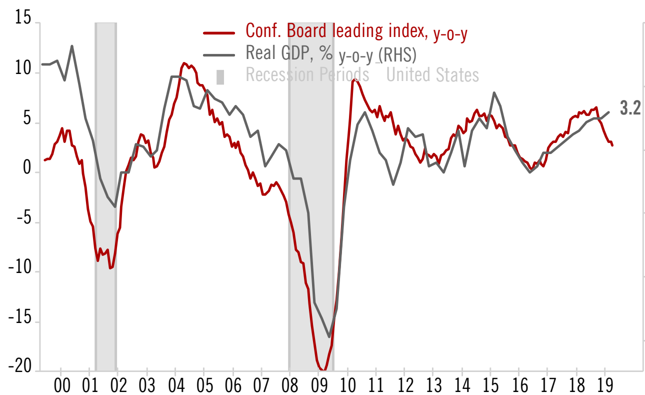
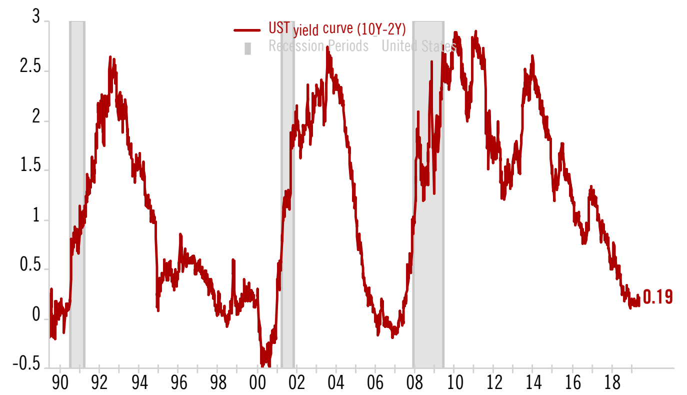
CONF. BOARD LEADING INDEX, % Y-O-Y VS GDP GROWTH, % Y-O-Y



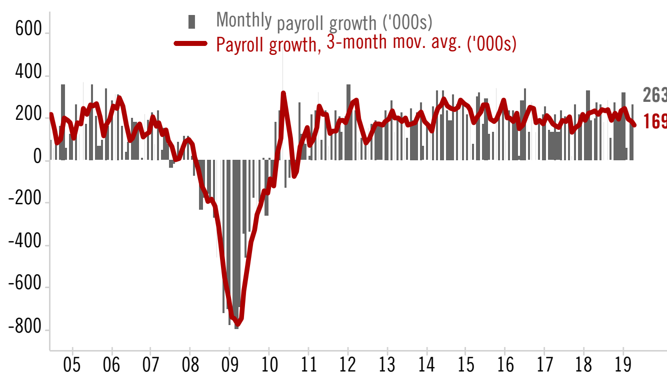
Source: PWM - AA&MR, Factset

US YIELD CURVE SPREAD (10-YEAR YIELD MINUS 2-YEAR YIELD)



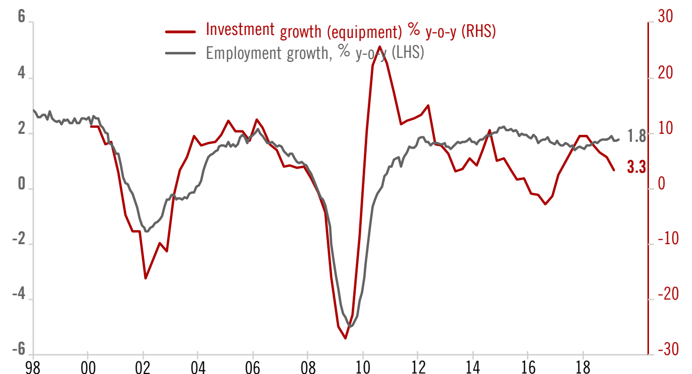
Source: PWM - AA&MR, Factset

EMPLOYMENT GROWTH, IN THOUSANDS OF PAYROLL ADDITIONS



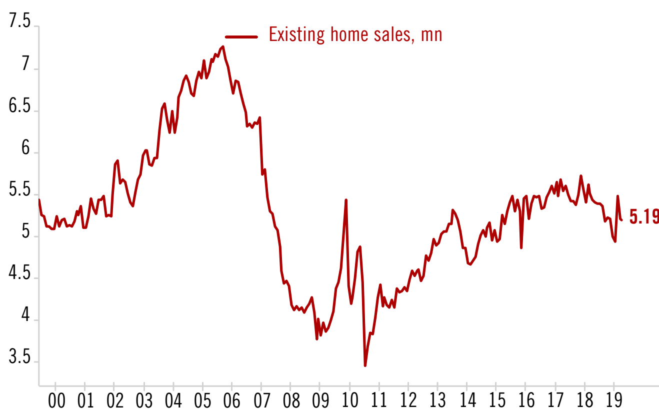
Source: PWM - AA&MR, Factset

US INVESTMENT (EQUIPMENT) VS EMPLOYMENT GROWTH, % Y-O-Y



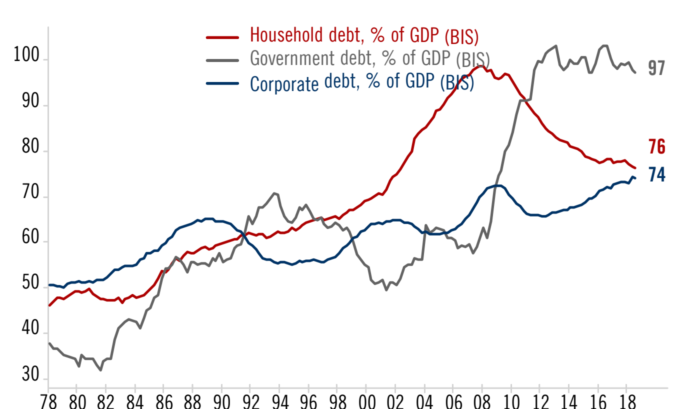
Source: PWM - AA&MR, Factset

EXISTING HOME SALES, MILLION UNITS (ANNUALISED)



Source: PWM - AA&MR, Factset

DEBT RATIOS (HOUSEHOLD, CORPORATE, GOVERNMENT), % OF GDP



Source: PWM - AA&MR, Factset

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