The Fed and the virtue of patience

With the Federal Open Market Committee (FOMC) resisting market pressures to enact monetary easing at its most recent meeting, investors are anticipating an interest rate cut later this year, possibly in September 2019.

The expectation for rate cuts comes as US-China trade tensions weigh into the broad macro outlook, alongside lower policy-rate projections and the language of the US Federal Reserve (Fed) shifting to an increasingly dovish tone.

Here are the key takeaways from the meeting:

- Federal funds rate unchanged in a range between 2.25% to 2.50%
- Increased likelihood (though not affirmative) of rate cuts later in 2019
- Uncertainty from trade wars are a reason for increased caution
- Fed officials cite that the current economic data does not justify policy easing

What are the reasons behind the Fed leaving interest rates unchanged at this time?

The hard economic data gives little justification for rate cuts. US unemployment rates are at 50-year lows (3.9%), while growth rates (3.1%) are above the Fed's long-run trend estimate (1.9%).

The Fed mandate reads "maximum employment, stable prices, and moderate long term interest rates". All three are not under threat at the moment. With employment seen as the leading indicator, the Fed might consider a cut should they see a substantial slowing in the 3-month average growth of employment, and/or a negative payrolls print, neither of which have materialised.

The Fed's first priority should be the real economy, and market conditions constitute a secondary priority (if there was one), in the event where market turbulence spills over to the real economy. Hence, the Fed has actually no urgency to embark on an easing cycle because US financial conditions remain accommodative.

What are the possible dangers of an interest rate cut at this time?

If the Fed fulfils market expectations of a rate cut at this time, it could create a precedent that risks market participants clamouring for rate cuts with mere signs of turbulence in the future. This creates a slippery slope downward where Fed is pressured by the market to ease rates.

Some investors had pointed to cuts enacted in 1995 and 1998 when the Fed was seen to have indulged market wishes, however, these cuts were preceded by either sharp falls in growth and/or inflation. In addition, in late 1998, officials were attempting to prevent the collapse of Long Term Capital Management, a massive hedge fund that would have potentially ignited a global financial crisis.

Furthermore, the Fed had more ammunition in terms of higher interest rates with the Fed funds rate at over 4%, and it is unlikely now that the central bank would want to dispose of that ammunition that it had painstakingly built up. The S&P index is just 2% off its all-time high, and it would be a stretch to suggest that there is a dire need to "smooth out the markets".

How did some market participants price in the possibility of a rate cut when the outcome was otherwise?

Remember in 2018, while the markets had priced in one Fed interest rate hike, the estimates indicated with the Fed's dot plot showed three projected hikes. This discrepancy exists because the market interest pricing of policy rates was different and had consistently been below the FOMC's median dot.

Why did some investors expect that the Fed will actually cut rates in June 2019?

When Fed Chair Jerome Powell said the central bank will act appropriately to sustain economic expansion, the market mistakenly interpreted the statement; that the central bank would support growth at current levels.

The more likely explanation was that the Fed would support growth such that it does not fall below 1.9%. It seems unlikely that Fed members would downgrade 2019 growth, especially after the upside surprise in Q1 2019 GDP growth (3.1% vs expected 2.3%) that emerged after the last summary of economic projections from the FOMC. If anything, growth for the current year is likely to be revised up rather than down.

Are the chances of a Fed interest rate cut higher at the FOMC meeting in September 2019?

The short answer is yes. According to the Fed dot-plot, 7 out of 17 Fed officials think it would now be appropriate to lower the benchmark overnight rate by a half-percentage point by the end of the year. Powell himself has also iterated that trade wars and their potentially dampening impact on growth were a major factor behind Fed's shift to being dovish, along with weaker-than-expected inflation.

However, there is no complete certainty of the Fed slashing interest rates in September 2019. Though Powell is more willing to entertain the possibility of a rate cut, he mentioned the Fed needs a clearer read on whether the economy needs easier credit "in the very near term''.

What events are we watching that will influence the outcome of the next FOMC meeting?

The G20 meeting in Japan (on June 28) between the Presidents of the US and China will provide more clarity to the state of trade talks that the Fed will use to assess growth developments. A breakdown to talks and the effect of US$320 billion in tariffs on Chinese imports would mean growth headwinds and an increased likelihood of the Fed easing rates.

House view

In an environment of moderate and global growth slowing down in a late cycle, we think the outlook for fixed income becomes increasingly attractive and the outlook for equities becomes more uncertain. Within equities, we expect the trade conflicts to be negative for emerging markets that are more trade dependent. We thus overweight developed market equities and underweight emerging market equities.

With the Fed widening the possibility of easing, 10-year US Treasury yields have slipped below a key support level of 2% which may seem over-discounted in the near team. Over the medium term, we are long on duration for fixed income, particularly in a global environment where French yields are negative and Bund yields are printing all-time lows. We also focus on solid investment grade bonds.

We are neutral on the USD. Though the outcome of the FOMC meeting is negative for the greenback, recovery may occur if other central banks attempt to outdo the Fed in terms of dovishness. The European Central Bank has already invited more easing, and we could see the likes of Australia and New Zealand follow suit, which would be overall positive for USD. Hence, a net effect for the USD would be that it could hold up in the short to medium term (1 to 3 months) before falling in the longer term (6 months to 1 year).

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