UOB Asset Management

Insights

Fed does a 1990s playback with a cut

The US Federal Reserve (Fed) has lowered interest rates by a quarter of a percentage point amidst sustained political and mounting market pressures to reduce rates. Federal funds rate is now in a range between 2.00% to 2.25%.

Chairman Jerome Powell stated that this was “not the beginning of a new easing cycle”. Instead, he reiterated it as a mid-cycle adjustment to weather downside risks including weakening global growth and trade uncertainties between the US and China.

Market reaction

While the move was widely expected, Powell’s hawkish tone took market observers by surprise and dampened hopes for a series of cuts. This opened the door to a potentially slippery slope where markets could pressure the Fed to ease rates upon signs of vulnerability in financial asset prices.

Averting recessions

Mid-cycle interest rate cuts are not new as the Fed enacted similar measures in 1995 and 1998 to prolong economic expansion. This also had the consequence of inflating asset prices. In 1995, the S&P 500 gained 13 per cent in six months after the first cut while gains shot up to 29 per cent for 1998. During those periods, growth levels were moderately low and macro events (Asian financial crisis and Russian financial crisis) threatened to drag US domestic growth lower which is similar to the situation today. Back then the policy was viewed as prudent, however, in hindsight, the protracted period of low interest rates helped sow the seeds for the Dot Com bubble.

Fast forward to today, and interest rate cuts may now be insufficient to stabilise slowing growth. Brexit, issues surrounding Iran, North Korea, and other trade related skirmishes, etc are accumulating external risks that could yet further weigh down on the global economy.

Strong USD

Much of recent evidence has shown that even central banks who met market expectations (such as the European Central Bank) saw their currencies strengthen in the aftermath of meetings. This was simply because dovish expectations have been overpriced and markets quickly move to focus on the next upcoming (dovish) central bank meeting. As such, since the Fed deviated from expectations, the USD is poised for a short to medium term rally, possibly through to the next Federal Open Market Committee meeting in September 2019.

House view

Both equities and fixed income markets could be disappointed if the markets over price future rate cut expectations. We expect a total of one to two Fed rate cuts for 2019, which is lower than the two to three cuts priced in by markets.

UOBAM favours an overweight on fixed income and staying underweight on equities as growth risks continue to loom. In the fixed income segment, we continue to like the investment grade segment as looser monetary policy (from the Fed and other central banks) would have the effect of tightening credit spreads. In an environment of low and positive economic growth, investment grade bonds tend to deliver returns that are above average and the high yield segment will deliver average returns at best. The outlook for global equities remains less clear as the cycle is already mature and equities would be vulnerable if global growth slows further from current levels. Although pre-emptive “insurance cuts” have the effect of bolstering market optimism by helping to sustain the ongoing US economic expansion, these policy cuts could potentially inflate asset prices to elevated levels.

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