Active is: Anticipating what's ahead

A major about-turn for the Fed

by Franck Dixmier | 25/07/2019

Summary

In the face of slowing global economic growth, continued trade tensions and the prospect of a "hard Brexit", the FOMC seems set to announce a reduction in interest rates at its next meeting. We expect a 50-basis-point cut that will start a new rate-cut cycle, and we think the markets should react favourably.

Key takeaways

- The FOMC meeting on 30-31 July seems likely to mark a major turning point in monetary policy for the Fed
- The Fed appears set to enter a rate-cut cycle; we expect the FOMC to announce a decrease of 50 basis points
- Given a weakening global economy and persistent trade tensions, the Fed likely wishes to act pre-emptively as an exercise in risk management
- Markets might be surprised at the news, but will likely react positively given the historically favourable impact of rate cuts on equity markets

It now seems likely that the US Federal Reserve will initiate a rate-cut cycle at the 30-31 July meeting of the Federal Open Market Committee. Paving the way for this decision were a range of recent announcements from FOMC members – including statements by Fed Chair Jerome Powell, Fed Vice Chair Richard Clarida and New York Fed President John Williams – as well as the minutes of the last FOMC meeting.

US economic data such as job creation, retail sales, production and inflation rose surprisingly in June, and they show an economy that is still robust. However, the Fed no longer seems to base its policy-making on data. It appears to be focusing instead on slowing global economic growth, which leads to diminishing demand, and on the high-risk environment stemming from trade tensions and the prospect of a "hard Brexit".

The Fed's likely decision to lower rates would therefore appear to be based on its approach to risk management: if doing less appears riskier than doing more, then the Fed feels justified to do more now than would otherwise seem necessary.

Market expectations of a 50-basis-point rate cut as early as July have been quite volatile, recently dropping from 40% to a lower level, according to fed funds futures. However, we believe that the Fed's risk-management policy justifies a 50-bp reduction. There are two arguments for this:

- Today's interest-rate level, which is near the "zero lower bound", encourages the Fed to take voluntary action to maximise its effectiveness.
- Given the delay in transmitting a rate cut to the real economy – transmission takes between six and 12 months – the Fed may feel it has no time to lose and could want an insurance policy.

It should also be noted that the Fed is experiencing pressure from two fronts. President Donald Trump and the markets want a rate cut, and the Fed is also feeling pressure to address the US dollar – which some economists estimate is overvalued by around 10%. Despite what central bankers say, maintaining a desired exchange rate seems to have become an unacknowledged objective.

If the Fed decides to cut rates, the markets might be surprised but should react favourably. We think a 50-bp cut will lead to a "bull-steepening" phenomenon, a compression of spreads, a lower dollar and the continuation of a dynamic that is beneficial for the equity markets.

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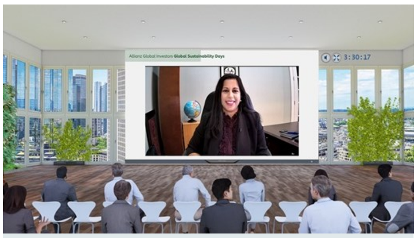

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The ECB is getting its tools ready

by Franck Dixmier | 06/09/2019

Summary

In recent months, the ECB made it clear that it will use all necessary measures to preserve growth and increase inflation in the euro zone. Since then, the political and macroeconomic environment has

deteriorated, so we expect the ECB to announce new monetary-stimulus measures at its next meeting.

Key takeaways

- We except the ECB to announce concrete monetary-stimulus measures at its 12 September meeting, in line with the comments it made in July
- Among the likely announcements are a rate cut, a new multi-tier deposit facility for banks and enhanced forward guidance – but we don't expect the launch of a new asset purchase programme given the lack of consensus among ECB members
- Markets will likely be disappointed, which would give investors an opportunity to take advantage of tensions in interest rates and spreads

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