Active is: Anticipating what's ahead

Balancing exercise mandatory for the Fed

by Franck Dixmier | 17/06/2019

Summary

Markets are keenly awaiting the next monetary policy meeting of the US Federal Reserve, which will take place on 18 and 19 June.

Key takeaways

- The Federal Open Market Committee meeting comes as the US Federal Reserve (Fed) is under constant pressure from the markets and the White House
- Even if the Fed's next move should be a rate cut, at this stage it seems unlikely that this decision will be announced as early as 19 June
- Market disappointment could lead to a rate correction, which should encourage investors to take longer duration exposure in their US bond portfolios

The escalation of trade tensions between the United States and China has caused investors to fear a sharp slowdown in global growth; equity market volatility has risen again; while inflation expectations have continued to fall, with the 5-year/5-year inflation swap rate falling to 2.03% in early June - despite a slight rebound in core inflation in April - and the Core Personal Consumption Expenditures rising from 1.5% in March to 1.6% in April. As a result, markets are now anticipating just over three 0.25% or 25bps rate cuts over the next 12 months, including a little more than two by the end of the year. In addition, political pressure is increasing, as President Trump wants to maintain economic activity at all costs.

Jerome Powell, the Fed President, will therefore have to engage in a balancing act: if the resilience of the US economy, which remains robust, does not provide him with an argument justifying a change in monetary policy, he should nevertheless indicate that the central bank is ready for a "Fed Put" if necessary to offset the negative effects of trade tensions.

This would prove it is listening to the message sent by the markets not to tighten financial conditions. In a speech delivered in Chicago on 4 June, Jerome Powell said he was closely monitoring the impact of the tensions and stood ready to act appropriately if necessary, thus opening the door to a rate cut without explicitly mentioning it.

It now seems very likely to us that the Fed's next move will be a rate cut, not an increase. However, we believe that the Fed will not take a decision at the 19 June meeting. There are several reasons for this:

- The US economy is resilient, supported by household consumption, and the full employment target has been exceeded. The Fed needs more time and real data to adjust its forward guidance downwards, and this would need to include converging indicators confirming a real deterioration in activity.
- The normalisation of monetary policy was put on hold after nine rate hikes, with Fed Fund rates fluctuating between 2.25% and 2.50%, from historically low levels. The central bank's room for manoeuvre is therefore limited: rate cuts will be a scarce resource, the timing of which must be particularly well gauged in order to guarantee maximum efficiency.
- US Equity markets, despite volatility, are close to historical highs, and continue to experience one of the longest upward cycles in history.
- Finally, Jerome Powell must avoid a monetary policy error at all costs: even if it is unlikely, the possibility that a favourable trade agreement between the

United States and China will be reached cannot be excluded. This could revive the American economy and lead to increased inflation, and inflation anticipations.

Given high market expectations, a speech that is less dovish than expected should temporarily disappoint investors in both equities and bonds. We believe that any correction in US rates would provide an opportunity to take some duration in US bond portfolios.

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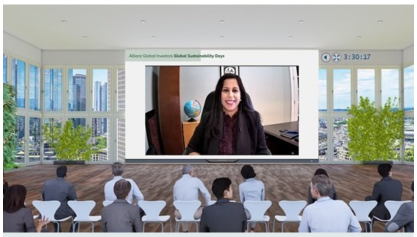

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The ECB is ready to take action

by Franck Dixmier | 17/06/2019

Summary

The ECB's next meeting on 25 July is of major importance, and markets should welcome confirmation of its

new forward guidance. We expect the central bank to reaffirm that it has the will to support growth and manage inflation, and the tools needed to take action.

Key takeaways

- At the ECB's next meeting, we expect confirmation of the statements Mario Draghi made in Sintra on 18 June: the central bank is ready to take all measures to support growth and move closer to its inflation target, and will likely provide new forward guidance
- We do not expect any concrete action until the ECB's September meeting, which should open a sequence of lower deposit rates followed by the launch of an asset-purchase programme at the end of the year
- The official confirmation of this new forward guidance should be welcomed by the markets, and should help anchor rates at extremely low levels
- We have entered an undeclared currency war

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