Manulife Asset Management

Market Note

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The US Federal Reserve (Fed) trimmed rates by 25 basis points (bps), as has been widely expected. Frances Donald, Chief Economist and Head of Macroeconomic Strategy, believes that the Fed's going to cut at least once more, probably in September, and the 2016/2018 hiking cycle is now over. Donald also explains why Wednesday's interest-rate decision is far more significant than it may initially seem.

The Fed's next chapter: this is no regular interest-rate cut

The majority of media coverage and market commentary we've seen so far has focused on what the Fed did on Wednesday, that is, the quantum of the rate cut and the ensuing market reaction. The "what" was relatively straightforward:

- Interest rates were cut by 25bps.
- The Fed's balance sheet runoff known as quantitative tightening (QT) now ends as of 1 August, two months earlier than initially planned. This makes sense: Why ease with one tool but tighten with another?
- The interest rate it pays banks to park their excess reserves at the central bank was cut by 25bps, from 2.35% to 2.10%.

However, we believe the why—the rationale behind the Fed's decision—is far more important. Unfortunately, it's also more difficult to discern. Formally, the Fed's statement implies the decision to cut rates was fairly broad, attributing it to "the implications of global developments for the economic outlook as well as muted inflation pressures." However, during Wednesday's press conference, Fed Chair Jerome Powell also continued to emphasise that the Fed's base case for the economy is "a positive one" that includes a sustained economic expansion[1]. In which case, why cut? We believe the Fed is substantially more focused on inflation and inflation expectations than its statement formally alludes to, and its desire to boost price pressures is the primary driver behind Wednesday's rate cut—and for that matter, any forthcoming rate cuts.

Investors are likely to have come across two different broad sets of narratives explaining the Fed's decision to embark on a rate-cutting path. The first, favoured by a group of market watchers who belong to what we call the "**easing cycle**" camp, suggests this could mark the beginning of a more typical Fed-easing cycle, similar to the majority of those seen in the past three decades. On average, easing cycles tend to produce around 500bps of rate cuts and are typically a reaction to an economy that's already in, or is heading toward a recession. In the current environment, a traditional easing cycle would imply that the Federal Open Market Committee (FOMC) will take rates to 0% or below and that the US 10-year Treasury yield will also fall to zero, which will likely be accompanied by some pain for risk assets. Admittedly, after Wednesday's surprisingly robust press conference, this narrative is likely to be relegated to the sidelines … at least for now.

[1] "Federal Reserve issues FOMC Statement," federalreserve.gov, 31 July 2019.

The second narrative, advocated by those in the "**insurance cuts**" camp, suggests that these cuts—which typically involve lowering rates by a total of 75bps in one or two increments—are intended to offset short-term cyclical weakness in US growth, in this case, because of trade tensions and weak global manufacturing activity. The Fed has acted similarly (twice) in the 1990s: It most famously undertook this approach in 1995 and again in 1998.

Fed Chair Powell's insistence during Wednesday's press conference that the Fed is engineering a "**mid-cycle adjustment**"[2] is far more consistent with the insurance cuts camp versus the easing cycle camp, and markets appear to be unwinding a good deal of their easing cycle pricing.

We believe the narrative needs further refining. In our view, **the Fed could be engaging in an important variation of the insurance cut** that it hasn't done before, which we call the "**reflation cut**." These cuts aren't primarily designed to support short-term growth (although that's a helpful offshoot, particularly in an environment defined by elevated uncertainty), or as a response to recession risk. Instead, they're undertaken to produce a structural inflationary overshoot and to reignite persistently weak inflation expectations that have become de-anchored from 2%. If this is indeed the case, by explicitly attempting to engineer greater than 2% inflation, the FOMC will likely contribute to an overheating of the US economy.

The most important difference between a typical insurance cut and our theory of reflation cuts is that central bank dovishness doesn't end when growth reaccelerates; it only ends when inflation has persistently overshot 2%. This implies that (a) the Fed's likely to stay on hold once it's done cutting for a prolonged period of time, longer than it would have done in an insurance cut environment, and (b) risk assets could benefit from both lower rates and stronger growth.

Our key takeaway from Wednesday's press conference is that it confirmed our belief that the Fed's trying to ease its way into an economic stabilisation (and potentially into a reacceleration). In other words, we believe Wednesday's interest-rate cut is indeed a "mid-cycle adjustment"[2] designed to stoke inflation. This is consistent with our near-term market views that:

- Risk assets can continue to do moderately well, as these cuts will support the extension of the economic cycle.
- No substantial repricing at the front-end of the yield curve because in our view, interest-rate cuts of between 50bps and 75bps followed by a long pause is consistent with the reflation cut mandate of two to three interest-rate cuts.

Ultimately, regardless of which camp we end up belonging to, the broader story is clear: The Fed's going to cut at least once more, probably in September, and the 2016/2018 hiking cycle is now over.

[2] FOMC Press Conference, federalreserve.gov, 31 July 2019.

Interest-rate cuts: three different narratives

Narrative Type	Notable periods when it has been deployed	The average magnitude of rate cut	Characteristics
Easing cycle cuts	1989–1993; 2000–2003; 2007–2009	500 bps	• Employed towards or during the end of an economic cycle to combat an impending recession • Historically associated with recession and therefore negative for risk assets • Rate cuts end as the economy enters a new growth cycle
Insurance cuts	1995–1996; 1999	75bps	• Employed to fend off expected near-term economic weakness • Rate cuts end once the economy stabilises and/or downside risks fail to materialise • Historically positive for risk assets
Reflation cuts (a variation of insurance cuts)	*Untested*	50-75bps	• Employed to ignite inflation and inflation expectations, with the implicit intention of allowing inflation to overshoot the official target, and the US economy to overheat in the short term • Rate cuts only end when inflation undershoot is corrected, implying risk assets can substantially benefit from lower rates *and* better economic growth

Source: Manulife Investment Management, 30 July 2019.

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