Morgan Stanley

INVESTMENT MANAGEMENT

Global Factors Impacting the Fed's Rate Policy

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AUTHOR

JIM CARON
Managing Director
Portfolio Manager
Global Fixed Income Team

My sense is that Jerome Powell, Chairman of the U.S. Federal Reserve, is more concerned about global financial conditions, namely weak global PMIs, low global inflation, and weakening growth everywhere, than he is pacified by a strong U.S. labor market. The Fed detailed the idea of incorporating global factors into their policy reaction function in a June 2019 paper entitled: Monetary Policy & Financial Conditions: A Cross Country Study.[1] Here they introduce an 'augmented' Taylor Rule[2] that adds the notion of GDP-at-Risk by incorporating financial conditions alongside the already familiar inflation and full employment variables. I see this as an important development; this deserves more attention than the market is currently paying towards it because it explains the Fed's policy reaction function today.

The market is currently pricing a 25 basis point (bps) interest rate cut by the Fed in July. However, I think a higher probability should be assigned to a 50 bps rate cut.

The Fed's thinking may be as follows: they need to cut rates by at least 50 bps this year, so why wait? They can cut rates by 50 bps in July and then still have the flexibility to cut another 25 bps later in the year if needed.

Furthermore, if the Fed is thinking along the lines of risk management, they may be more inclined toward a 50 bps cut. If there is in fact evidence of a more substantial weakening of U.S. and global growth, then a 25 bps cut is less effective versus a 50 bps cut, as the later would give the Fed extra

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[1] June 2019 Federal Reserve Bank of New York Staff Reports. https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr890.pdf

[2] The Taylor Rule is an approximate gauge of how quickly the nominal interest rate set by central banks will respond to changes in inflation, economic output and other economic conditions.

"insurance" against a declining market. The Fed could then opt not to cut further if economic activity picks up.

I realize my view goes against the market consensus, but in order to better understand the Fed's reaction function we need to appreciate that it is increasingly evaluating financial conditions both in the U.S. and around the globe.

If you evaluate their actions through that lens, then a 50 bps cut doesn't seem so unreasonable, or unlikely; perhaps Chairman Powell wants to keep this ("put") option open. In conclusion, Powell may not push back on a 50 bps rate cut as much as the market was thinking.

Display 1: Then & Now…

	JANUARY 1, 2019 **Known Unknowns**		AS OF TODAY **Known Knowns**
Fed Policy	Neutral or tighter	→	Expected to ease (possibly 100 bps over next 12-months)
U.S.-China Trade Deal	Deal expected by May	→	No Deal. No urgency for a deal either
Credit	Risk of wider spreads	→	Spreads narrowed, may grind tighter
Volatility	Expected to rise	→	Declined, may stay low
Consensus range for U.S. Treasury 10-year Yield	2.75% - 3.25%	→	1.75% - 2.25% (i.e. 100 bps lower)
U.S. Dollar	Crowded long/expected to strengthen	→	Near unchanged, longs liquidating

A Note on Emerging Markets

We believe that emerging market (EM) fixed income may have the most upside surprise potential for the second half of 2019.

- The increase in asset price valuations based on an unexpected decline in interest rates may be over for 2019.
- Volatility may remain low as easy global central bank policy settles into markets.
- Investors may continue to reach for yield.
- Credit spreads may grind tighter, but marginally.
- Global inflation to likely to remain low.
- EM central banks have more scope to ease as global inflation remains low and developed market central banks are not hiking rates.

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