Morgan Stanley

INVESTMENT MANAGEMENT

A Fed Mistake?

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AUTHOR

JIM CARON

Managing Director
Portfolio Manager
Global Fixed Income Team

As we see it, the measures of success for the U.S. Federal Reserve (Fed) July meeting policy decision were for the yield curve to steepen and for the U.S. dollar to weaken. The opposite happened: the curve flattened and the U.S. dollar rose. This signals to us that the Fed made a policy mistake by cutting rates 25 basis points (bps) instead of 50.

We have been strong advocates of a 50 bps rate cut despite the overwhelming market consensus for a 25 bps cut. The Fed delivered on market expectations, but missed on meaningful guidance during its press conference. The market expected a 25 bps rate cut alongside dovish guidance, but Fed Chairman Jerome Powell did not communicate this to the market. Our rationale for a 50 bps cut was as follows:

- The Fed is missing low on its inflation target with the core personal consumption expenditures price index (PCE) at 1.6%
- The Fed needs to steepen the yield curve
- A vicious cycle exists: A stronger U.S. dollar pushes inflation lower and further away from the Fed's target. This is especially true if other global central banks adopt easier policies that would strengthen the U.S. dollar on a relative basis.
- The Fed needs to overweight the importance of reaching their inflation target. Why?
    - Because disinflation reduces long-term trend consumption (70% of gross domestic product)[1]
    - Manufacturing, capital expenditures and the supply side of the economy are all slumping (globally too)

Nevertheless, this event does not serve as a catalyst to materially change current portfolio positioning at the moment.

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[1] Source: Bureau of Economic Analysis. June 30, 2019.

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