16 August 2019

FOMC research

New Fed call: Five more from Fed

Key takeaways

- **We now expect five more 25bp cuts, taking the target range to 0.75-1.00% at the March meeting. We do not anticipate the Fed will pre-commit to more easing but that it will stick to its current ad hoc approach.**
- **If the Fed really wants to reflate the economy and markets, it may need to commit more to easing and/or cut more and faster eventually.**
- **We have lowered our 10Y Treasury yield forecast to 1.30% in 3M, 1.00% in 6M and 1.20% in 12M (see page 2).**
- **We keep our views on the FX majors unchanged and see EUR/USD at 1.10 on 1-3M on a new round of Fed disappointments, before moving higher to 1.13 in 6M and 1.15 in 12M (see page 2).**

Fed outlook: Five more 25bp cuts

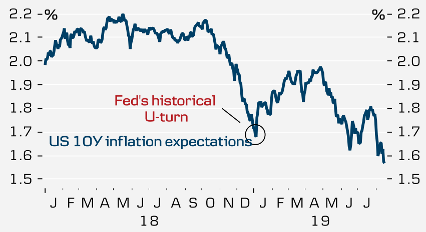
Based on recent developments, we have changed our Fed call accordingly and now expect the Fed to deliver a 25bp cut at each of the next five meetings. If we are right, the target range would be lowered to 0.75-1.00% at the March meeting.

At the July meeting, the Fed gave three reasons for cutting: (1) higher (trade) uncertainty, (2) slower global growth and (3) inflation remaining below 2%. Since the meeting, we have seen an escalation of the US-China trade war (although the next round of tariffs has been delayed by a couple of months) and risk sentiment become shakier. One important indicator for the Fed is the US 2s10s spread, which reversed this week. Economic indicators outside the US have been weak, with weaker-than-expected Chinese data for fixed asset investments, industrial production and retail sales, German GDP contraction in Q2 and a very downbeat ZEW survey. While actual US CPI inflation has surprised to the upside in recent months, market-based inflation expectations are low (1.6% versus 1.7% when the Fed started its U-turn) and it is difficult to see any reasons why inflation should accelerate out of control any time soon. US retail sales were strong, however.

Despite our new, more aggressive Fed call, we do not expect the Federal Reserve to pre-commit to further easing but instead expect it to stick to its current ad hoc approach, at least in the near term. We expect the Fed will repeat its easing bias in the statement by saying it *"will act as appropriate to sustain the expansion"*.

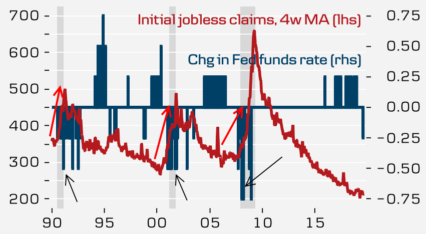
It is natural to ask why the Fed is moving slowly instead of making bigger cuts (50-75bp), especially with markets pricing in an approximately 40% chance of a 50bp cut next month. A large cut of 50bp or more still seems overly stretched to us. Historically, larger cuts (and cuts between meetings) have happened when the US is already in recession with increasing unemployment. Initial jobless claims have, for example, risen prior to all larger cuts since 1990. The Fed is recognising that the macro outlook has become more uncertain but still sees its easing cycle as a "mid-cycle adjustment" and not recession cuts. In our view, US growth has peaked and will likely slow but we do not expect a recession to show up in the data near term (depending on Fed action).

Fed still fighting low market-based inflation expectations



Source: Bloomberg, Macrobond Financial

Fed does not usually cut by more than 25bp per meeting outside of recessions



Source: Department of Labor, Federal Reserve, Macrobond Financial

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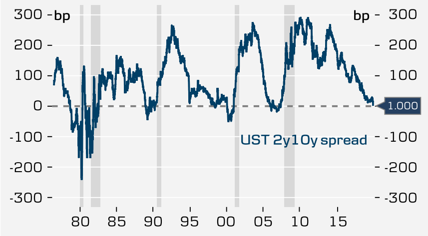
The combination of the Fed not pre-committing to easing and only cutting by 25bp means that markets may continue to get disappointed, as expectations are high. As mentioned, the market is pricing in around a 40% probability of a 50bp cut at the September meeting. Our new Fed call is slightly more aggressive than currently priced in by markets but, in our view, current pricing seems fair when the Fed is not going to pre-commit to cuts. That said, if the Fed really wants to reflate the economy and markets (i.e. increase inflation expectations, get a strong relief rally in equities and an immediate steeper US curve), it may need to commit more to easing and/or cut more and faster.

Bond markets signal a recession is forthcoming



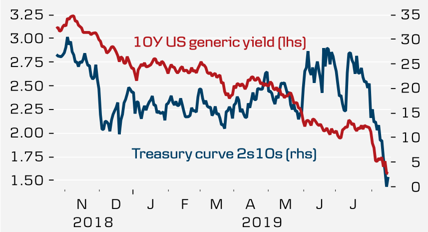
Source: Bloomberg, Macrobond Financial

FI outlook: 10Y US treasury yields to hit 1%

Our new 'five more from Fed' forecast that would bring the target range to 0.75-1.00% is more dovish than priced in by the market and, as such, we should also expect longer-dated yields to drop further. We assume that the market would continue to price in rate cuts in the money market curve even after five rate cuts. We now expect 2Y treasury yields to drop to 0.80% on a 6-12M horizon.

The big question is whether the Fed is capable of re-steepening the curve 2s10s after it inverted Wednesday for the first time since 2007. Normally, the US curve steepens as the Fed starts to ease monetary policy, as it creates optimism and pushes inflation expectations higher. However, we are in doubt whether this will be the case to the same degree this time, though we do forecast a positive yield curve 2s10s on a 6- and 12-month horizon.

Lower yields and still a flat curve



Source: Bloomberg, Macrobond Financial

First of all, we believe the Fed will be reluctant to pre-commit to an easing cycle. Hence, the market is likely to continue to see the Fed as being 'behind the curve'. It implies that the normal upward pressure on inflation expectations, for example, will be difficult to achieve. Second, long yields are not only lower due to Fed policy. The drop in neutral real rates has also played a role, and the negative 10Y JGB and Bund yields also mean that investors would be happy to buy US treasuries if the curve steepens. Finally, we are not calling for a sharp recovery in the US economy or risk appetite despite the monetary easing. Hence, there would be no cyclical upward pressure on long yields as we see it.

All in all, we have decided to lower our 10Y Treasury yield forecast to 1.30% (3M), 1.00% (6M) and 1.20% (12M).

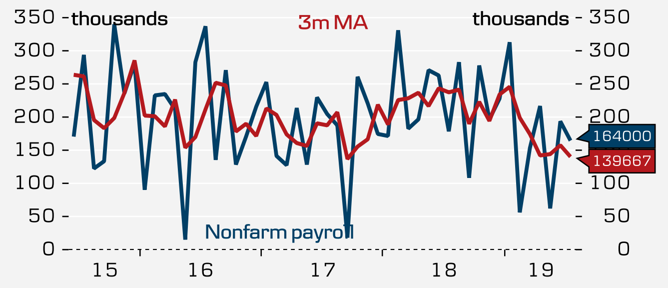
FX outlook: Yen appreciation not over, weaker USD not before 2020

The Fed is currently chasing the market, which means that even though we are looking for more Fed cuts now, we keep our views on the majors unchanged. Overall, we still see potential for a weaker USD on a Fed-inspired global reflationary push. However, as the Fed looks unlikely to accommodate the market's call for rate cuts larger than 25bp, we need to get deeper into the easing cycle before we see this push. Timing-wise, the pivotal moment for the USD could come around the January FOMC meeting, as the world looks now. We therefore see EUR/USD at 1.10 in 1-3M on a new round of Fed disappointments and a move higher to 1.13 in 6M and 1.15 in 12M.

We expect the yen to continue to perform on the Fed extending the easing cycle further. Our 3M USD/JPY forecast of 105 is well within reach and we think we could easily see an undershooting of this. For EUR- or DKK-based clients hedging USD assets, we still see value in extending hedges in FX forwards beyond year-end, as Fed rate cuts seem about fairly priced on this horizon and as we see risk of a further widening in the EURUSD OIS basis over year-end (see *FX Strategy EUR/USD FX forwards driven by turn pricing, debt ceiling and Fed*). Beyond year-end, risk-reward is for even lower USD rates.

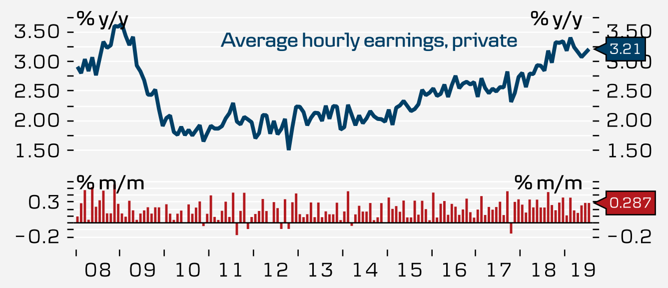
Charts

Employment growth has softened this year



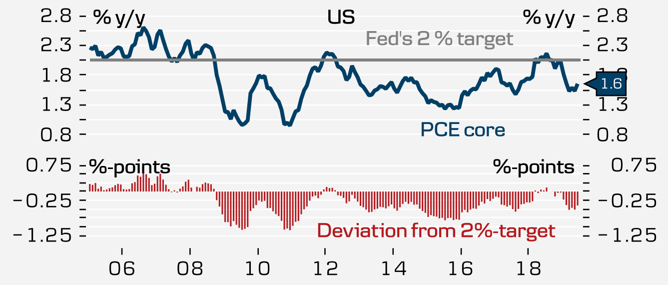
Source: BLS, Macrobond Financial

Wage growth seems to have peaked for now



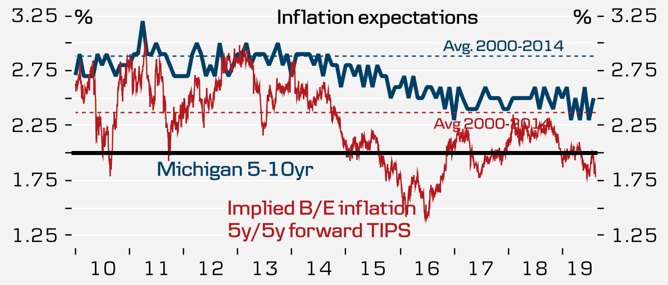
Source: BLS, Macrobond Financial

PCE core inflation is running well below 2% target



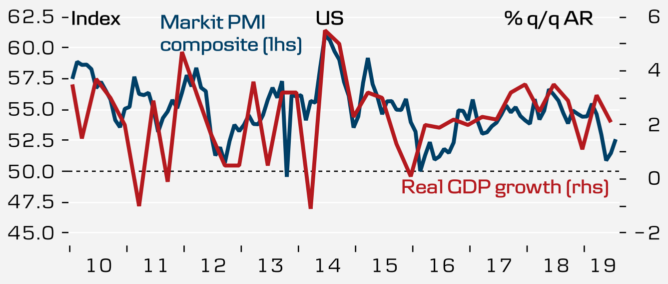
Source: BEA, Macrobond Financial

Inflation expectations remain subdued



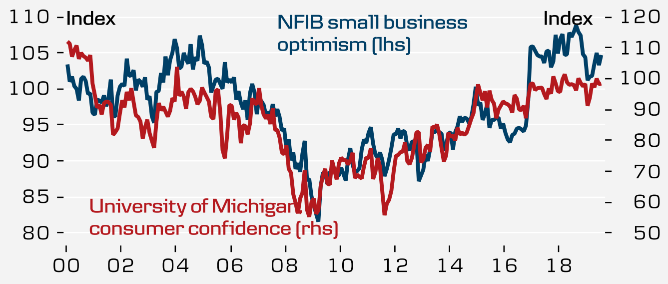
Source: Michigan, Bloomberg, Macrobond Financial

Markit PMI suggests weak growth in July (wrong signal in Q2, however)



Source: BEA, IHS Markit, Macrobond Financial

Still-high optimism



Source: NFIB, University of Michigan, Macrobond Financial

Disclosures

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