6/5/2019

What Will the Fed Do?

- Markets expect the Fed Reserve to cut interest rates.
- Many economic concerns are driven by the lingering trade war.
- We expect the Fed to remain on a wait-and-see data dependent approach.

Expectations surrounding future interest rates have dramatically changed since the beginning of this year. Heading into 2019, with a growing economy and potential trade war resolution, the markets priced in a 79% probability that the Fed would not raise rates this year. Today, however, markets have only priced in a 2% chance that rates will remain at current levels and an 85% probability of two or more rates cuts in 2019. The Fed is accomplishing its dual mandate for a strong labor market and stable prices. Outside of Fed Futures pricing in a greater likelihood of rate cuts, concerns about economic growth can be seen in the sharp decline in economically sensitive commodities such as copper, steel, and scrap metal. This can also be seen in the overall strength of the dollar and a three-week reversal in credit spreads.

Most potential economic derailments center around the lingering trade war. Because of increasing concerns that tariffs will raise costs and hurt growth, there has been a sharp decline in many key data readings, especially around manufacturing and the consumer. For example, recent manufacturing activity readings show the lowest levels in 2.5 years while forward-looking data, such as new factory orders, is at the lowest level in 10 years. On the consumer front, despite near-record confidence levels, 50-year low unemployment levels, and a one percent drop in mortgage rates over the past year, both retail sales and new home sales have been lackluster. Weaker economic readings, along with the backdrop of fading fiscal stimulus, have led to a sharp decline in GDP expectations (3.1% for Q1 to current estimates of 1.3% for Q2).

While the markets have placed a high probability that the Fed will cut rates this year, there are some reasons that the Fed may not cut rates. First, a resolved trade war, which is our expectation, could remove some of the obstacles to economic growth previously mentioned. Second, an unresolved trade war creates more inflation as costs rise year-over-year. Third, the labor market remains very strong and there has been a recent pick up in wage inflation. Fourth, the Fed wants to remain independent and cutting interest rates could raise questions about credibility given Trump’s demands for easing and that they raised interest rates just months ago.

Despite expectations of multiple rate cuts this year, we believe the Fed remains on a wait-and-see data-driven approach and will only ease if the economic outlook materially deteriorates, either because of serious market weakness or a broad decline in the incoming data. Fed Chairman Powell alluded to this plan in his recent comments this week. With this in mind, we expect significant market swings and overall elevated levels of market volatility as investors get readings on the economy and try to determine the Fed’s next step. It is of utmost importance that investors rely on their advisors, who are experienced in these types of environments, to help navigate these swings.

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