

GIAM Macro & Market Research - Market Commentary

The Fed cuts rates, but further easing requires a deeper slowdown.

- **As expected the Fed cut rates by 25 bps. However, the subsiding of political risks has convinced the Fed to pause easing.**
- **The moderate growth outlook is confirmed as well as that of inflation very gradually converging to the 2% target. The (tentative) softening in global uncertainty has reduced the downside risks to this outlook, which motivated the series of rates cuts.**
- **After this hawkish twist, the cut we penciled in for December is likely be moved into Q1 2020, as we expect by then a more pronounced slowdown of the economy.**

The Fed delivered a hawkish cut at its October meeting. The central bank bets on the improvement of the global political outlook, and that this would lift sentiment enough to keep activity running at the current pace. According to chair Powell, monetary policy stance is then “in a good place”: further cuts would be needed only in case data turn out to be much worse than expected.

Consequently, the press statement contained only minimal changes compared to September (see the comparison attached). The expected lack of unanimity was confirmed, but disagreement tended to err on the hawkish side, as two members would have preferred unchanged rates already at the October meeting.

During the press conference Powell outlined its view of the economy:

- GDP continues to growth at a moderate pace, thanks to the resilience of private consumption. A strong labor market, with rising wages and participation is instrumental to that, and the slowdown in payroll was widely expected and is not a cause for concern.
- The current weakness in investment is not due to financial conditions, which are not a key determinant of capex expenditure, but to uncertainty.
- The headwinds are related to weak global growth and the adverse effects political uncertainty is having on sentiment. But there are tentatively good news on the two main roadblocks: the signing of the “phase 1” agreement with China should defuse the risk of escalation and a hard Brexit has been avoided, for now. So the risk around the outlook are “moving in the right direction”.
- Inflation remains slightly below target, but will gradually converge to 2%.

Monetary policy was characterized as accommodative, as, after today’s decision, real policy rates are slightly negative and at the lower end of the range of R-star estimates. The series of cuts implemented since July are working with lags, supporting the most interest rate sensitive components of domestic demand like durables and residential investment (which bounced back in Q3). The current stance of monetary policy (i.e. the level of fed funds rate) remains appropriate if the economy develops as expected (i.e. it grows at the current or even slightly slower pace).

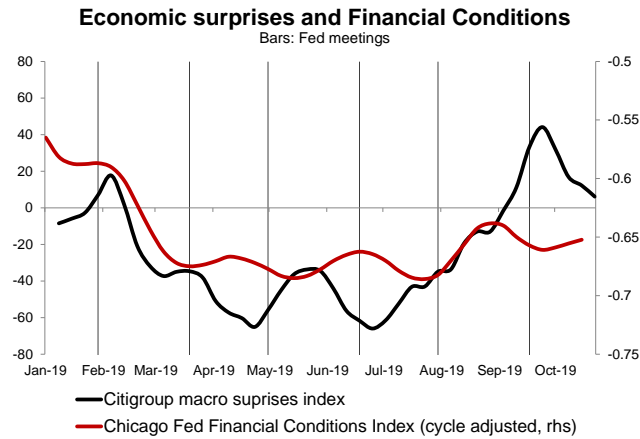
Bank liquidity is ample, and only technical tweaks are needed to make sure it flows smoothly. In order to facilitate that, the Fed will buy Treasury bills until 2Q20. Chair Powell stressed that Fed would buy bills and not long-term Treasuries.

In the end Fed has repeated the pattern of mid-cycle-insurance easing seen in the 1990s, where series of cuts totaling no more than 75 bps (the same size of the easing implemented since July) were needed to stabilize an economy weakened by global factors.

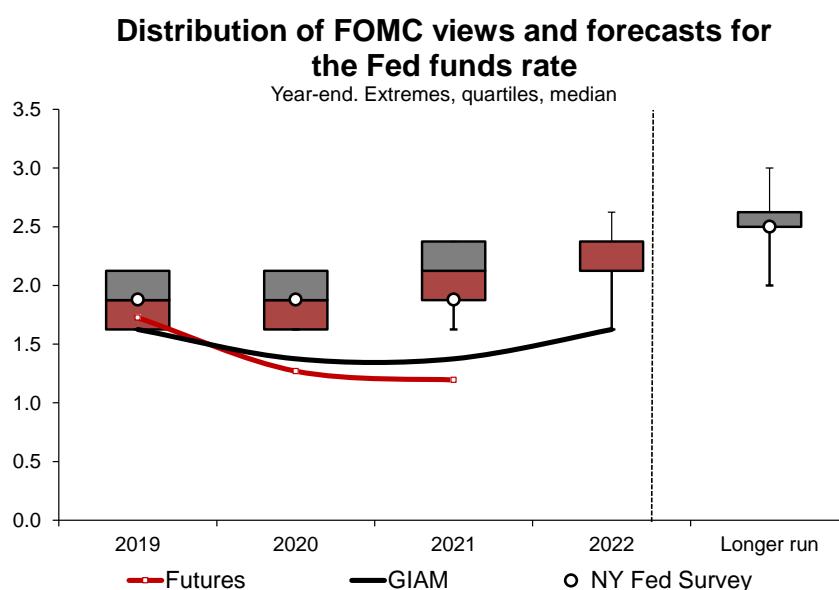
Is this time different? The global political landscape has indeed turned for the better over the next few weeks, and, if the improvement materializes, business confidence will gradually rise. However, the softening in trade tensions with China must not be overstated, and the probability of a return to a pre-Trump status quo are very

small. Therefore the slide in capex will moderate but it is difficult to expect a quick rebound, also because the weakness in global demand (against which the Fed cannot do much) will remain a drag.

Moreover, the improvement in economic surprises seen since the September meeting has proved temporary, despite very favorable financial conditions. The loosening in financial conditions was based to a large extent on expectations of further cuts by the Fed. Over the coming weeks we will assess to what extent the revision in expectations on policy rates will lead to tighter financial conditions.



We project growth to decline to 1.4 next, against 2% projected by the Fed, as slower employment growth and lower real wages will affect consumption, and as the limited impact the tax cut has had on domestic demand has waned. Therefore monetary easing will be needed; the cut we expected for December will be postponed to Q1 2020, likely to be followed by another one before the summer.



Growth projections for 2019 and 2021 increased marginally, but all the other median forecasts remained unchanged from the June meeting. The economy is seen to converge smoothly to the trend growth rate and core inflation will hit the 2% target no earlier than in 2021. The most important message on the macro outlook is the acknowledgment of **the split between an healthy consumer sector and a more troubles outlook for business which is cutting on investment in the face of weaker export**: this consideration was also the only notable change in the press statement. The labor market continues to power ahead and the slowdown in job creation is offset by the steady increase in labor market participation by prime age persons.

Slower growth in Europe and China continues to be seen as one of the two main headwinds coupled with political uncertainty, the “unsolved” Brexit issue and trade tensions. On the latter Powell reiterated that it is difficult to quantify its impact on the economy and that the most the Fed can is to look though the volatility in the negotiation and to loosen monetary policy to lower the interest burden and stimulate demand. **Powell almost explicitly stated that rate cuts are meant to prop up durable consumption and construction, implying that the weakness in corporate investment is solely due to trade and the Fed cannot do much to offset it.**

	2019	2020	2021	2022	Longer run
Change in real GDP	2.2	2.0	1.9	1.8	1.9
<i>June projections</i>	2.1	2.0	1.8		1.9
Unemployment rate	3.7	3.7	3.8	3.9	4.2
<i>June projections</i>	3.6	3.7	3.8		4.2
PCE inflation	1.5	1.9	2.0	2.0	2.0
<i>June projections</i>	1.5	1.9	2.0		2.0
Core PCE inflation	1.8	1.9	2.0	2.0	
<i>June projections</i>	1.8	1.9	2.0		
	<u>Appropriate policy path</u>				
Federal funds rate	1.9	1.9	2.1	2.4	2.5
<i>June projections</i>	2.4	2.1	2.4		2.5

Inflation deserved only a quick mention: it remains below the symmetric objective but efforts are needed to prevent expectations to deteriorate permanently.

Powell reiterated that the FOMC has changes quite rapidly its stance over the course of the year in reaction to economic developments. An unchanged economic outlook coupled with lower inflation and more uncertainty motivates the lower path for the fed funds rate decided in July. **He cited again the mid-90s episodes of middle cycle rate adjustment**, sticking to the script already presented in the last two meetings: **What the economy needs is a moderate adjustment and because of that decisions are taking “meeting by meeting” (but the dots show that guidance has strengthened)**; consistently he downplayed the projections for 2020 onward. The decision to enact further cuts will depend much on global growth and trade developments

Commenting the recent decision to inject liquidity in the market in reaction to spikes in the repo rate, Powell stated that this has no major implications for the economy and the Fed is committed to provide a sufficient supply of reserves in order to secure smooth market operations. In order to do that the interest rate on excess reserves (IOER) was cut by 30 bps.

On the proposal to turn to **negative policy rates** in case of a severe downturn, recently put forward by President Trump, this option was discussed in 2009 but **the preferred tools were (and remain) forward guidance and QE**. Powell also downplayed the risks to financial stability from low rates: household balance sheet are in a good shape and while there **are pockets of over indebtedness in the business sectors, these are deemed more an amplifier of a possible shock than a direct source of troubles**.

All in all **the decision and the tone of the press conference were not as dovish as market bet on, mainly due to a deeper as expected split among FOMC members**. However we remain convinced that **Q4 will bring another cut; its timing will depend on how political uncertainty are resolved. Brexit is likely to become the catalyst**. The October meeting will end just one day before the October 31 deadline the perspective of a crash exit will force the Fed to frontload the rate cut. **Given our more moderate growth forecast for 2020 (1.6% against 2%) we forecast another cut in the first quarter of next year**. Given the large uncertainty on global growth and the complicate geopolitical situation risks remain tilted toward a bolder easing.

Author:

Paolo Zanghieri

paolo.zanghieri@generali.com

www.generali-invest.com

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