QNB Economics
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US Fed’s “hawkish cut” offset by heightened trade tensions

Bond markets were particularly volatile in recent days. In fact, over the 72 hour period from July 30th to August 1st, market expectations about the future path of US policy rates fluctuated significantly. We explain these movements by delving into the ebbs and flows of US Federal Reserve (Fed) policies and trade tensions.

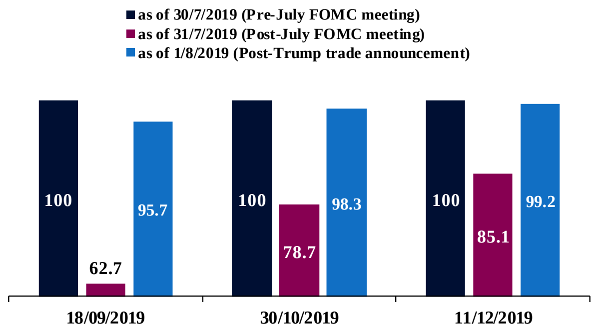
The initial movement in market expectations followed the 30-31st July meeting of the Fed’s Federal Open Market Committee (FOMC), when policy rates were cut for the first time in more than 10 years. The target for the fed funds rate was adjusted down by 25 basis points (bps) to 2-2.25%. The FOMC has also announced an early end of balance sheet normalization or quantitative tightening two months ahead of schedule. Official reasons for the actions included slowing global growth, trade policy uncertainty, muted inflation pressures and inflation expectations, and soft US manufacturing data.

Despite the Fed decision, markets have interpreted the official communication as “moderately hawkish.” After the FOMC meeting, market confidence in aggressive rate cuts diminished with the implied probability of further fed funds rate cuts dropping materially (see graph). The probability of rate cuts in the upcoming FOMC meetings in September, October and December fell from 100% to 62.7%, 78.7% and 85.1%, respectively. As a result, the USD strengthened and the US yield curve inverted further.

Two factors have led to such changes in expectations of future policy rates. First, as actions speak louder than words, the FOMC cut rates by only 25bps instead of the 50bps that some of the more aggressive bond managers expected. Second, the lingo used in both the official statement and the press conference was not supportive of an overly dovish Fed put. The rate cut was dubbed a “mid-cycle adjustment” rather than the beginning of an easing cycle. References to future actions and the need to monitor incoming data were watered down. This was amplified by the perception that there is no consensus within the Fed about how to proceed in this juncture. Several regional Fed governors opposed the latest rate cut.

In our view, initial market responses to the FOMC meeting did not lead to a disorderly tightening in financial market conditions. This would have given the Fed more flexibility to calibrate policy in a data responsive way.

Implied probability of fed funds rate cuts in 2019
(% probability of rate cuts in the next FOMC meetings)



Sources: Bloomberg, QNB analysis

However, president Trump’s decision to re-escalate the trade conflict with China completely changed the outlook. In less than 24 hours from the FOMC meeting, Trump announced the imminent imposition of 10% tariffs on the remaining USD 300 Bn Chinese exports to the US not already subject to tariffs. Sentiment plummeted immediately with safe-haven assets soaring and financial market conditions tightening. Bond markets immediately re-priced aggressive policy rate cuts, reversing the initial reaction from the FOMC meeting. In other words, the end of the trade truce between the US and China completely offset the Fed message.

Recent developments on the trade front are a major headwind. Confidence in bilateral US-China trade negotiations is eroding and the window for even a temporary deal is narrowing rapidly. This is to a large extent uncharted territory for the Fed. According to Fed Chairmen Jerome Powell, ‘t*rade is unusual. The thing is, there is not a lot of experience in responding to global trade tensions. So it is something that we have not faced before and that we are learning by doing. It is not exactly the same as watching global growth, where you see growth weakening, you see central banks and governments responding with fiscal policy, you see growth strengthening and a business cycle. With trade tensions, which are having* *a significant effect on market conditions and the economy, they evolve in a different way and we have to follow them*.'

In our view, heightened trade tension will continue to affect sentiment and tighten financial market conditions, i.e., increase the overall level of stress in money, bond and equity markets. The Fed will have to respond accordingly by easing monetary policy further. At the time of writing, we believe the Fed will cut rates by 50bps more in the remaining of 2019. But the balance of risks is now tilted to the downside as the environment is more likely to get worse than to get better. Should trade conflicts extend into currency wars and beyond, large doses of monetary stimulus would be needed, including more aggressive rate cuts towards the zero lower bond and the re-launching of asset purchase programs or quantitative easing.

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