Investment Event

20 June 2019
For Client Use

The Fed opens the door to rate cuts

At the June meeting, the Federal Reserve (Fed) left the Fed funds target range unchanged at 2.25-2.50%

The Federal Reserve left policy unchanged

The US Federal Reserve (Fed) left the target range for the fed funds rate at 2.25-2.50% at its June meeting; the market had been pricing a 20-25% chance of a rate cut. One of the ten voting members favoured an immediate 25bp reduction in the funds rate. The policy on the balance sheet was unchanged.

More dovish projections and statement

The Fed made important changes to its projections, revising down the paths for inflation and interest rates

The Fed made a number of important changes to its forecasts (Table 1). The median growth forecast was revised up a fraction in 2020 and the unemployment rate was nudged down in 2019-2021. However, the key changes were to the inflation projections and FOMC members' expectations for rates. These changes imply a more dovish outlook for policy.

1. Headline and core inflation were revised down in 2019 and 2020, to below 2%.
2. Seven out of seventeen members now expect the fed funds rate to be cut by 50bp this year with one further member seeing a 25bp reduction (previously no members were expecting a rate cut this year). By 2020, a majority of members expect the fed funds rate to have been trimmed, hence the median projection now shows a 25bp cut in 2020 (the March projections had pencilled in a rate *hike* for 2020)
3. The "longer run" fed funds rate was pushed down by 30bp to 2.50%, implying that the current level of the policy rate is not as accommodative as previously thought.

Increased uncertainty and muted inflation pressures mean the Fed has adopted a bias to cut interest rates

It is worth noting, however, that the median projection for the fed funds rate also shows a reversal of the rate cut by the end of 2021. This suggests that while the Fed is now willing to deliver some "**insurance**" rate cuts to lean against the risks that inflation remains below target for a prolonged period, or that growth unexpectedly weakens, it is not signalling the start of an easing cycle.

Table 1: FOMC median economic projections

	2019	2020	2021	Longer run
GDP (% yoy) *March*	**2.1** *2.1*	**2.0** *1.9*	**1.8** *1.8*	**1.9** *1.9*
Unemployment rate (%) *March*	**3.6** 3.7	**3.7** 3.8	**3.8** 3.9	**4.2** 4.3
Core PCE inflation (%) *March*	**1.8** *2.0*	**1.9** *2.0*	**2.0** *2.0*	**-** -
Fed funds rate (%) *March*	**2.4** 2.4	**2.1** 2.6	**2.4** 2.6	**2.5** 2.8

Source: US Federal Reserve

The Fed also made a number of changes to its statement that help explain its more dovish forecasts. It now refers to business investment as being "soft" and uses more direct language to describe the decline in market inflation expectations.

However, the key wording in the latest statement was that uncertainties surrounding the outlook have "*increased*" and *"In light of these uncertainties and muted inflation pressures, the Committee will closely monitor the implications of incoming information for the economic outlook and will act as appropriate to sustain the expansion"*.

This replaced the previous guidance that the Fed would be "*patient*" in determining the appropriate level of the fed funds rate. In our view, the change emphasises that the Fed now has a bias to cut interest rates.

Our views

We do not change our asset class views. Prospective risk-adjusted returns for developed market government bonds remain consistent with an underweight position in our global multi-asset portfolios

Market considerations

We remain comfortable with an underweight position in DM government bonds in our multi-asset portfolios, given low prospective returns. Moreover, while the Fed has opened the door to some modest easing of policy, market expectations for the extent of rate cuts look too aggressive, in our view. If the Fed is correct in its analysis of the economic outlook, there is scope for market rate expectations to retrace higher. Such a scenario would likely weigh on US fixed income assets.

The current level of bond yields means equity valuations remain relatively attractive and consistent with our pro-risk stance. The Fed's apparent willingness to ease policy to support US growth, which is still running at a reasonable pace, also argues for maintaining an overweight position in US equities.

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