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Amundi Pioneer
ASSET MANAGEMENT

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Signed, Sealed, Delivered: A Hawkish Fed Cut

INVESTMENT TALKS

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The Fed delivered a hawkish cut, its first since the Great Financial Crisis in 2008. While there was some debate whether the Fed might cut 50 basis points (bp), in the end the Fed cut the Fed funds target range by 25bp to 2.00%-2.25% at the July Federal Open Market Committee (FOMC) meeting. This was more or less in line with expectations. It was not a unanimous decision, as there were two dissenters, with Esther George of the Kansas City Fed and Eric Rosengren of the Boston Fed advocating no rate cut. But in the FOMC statement, the Fed cited concern about the implications of global weakness for the economic outlook, as well as muted inflationary pressures, as key reasons behind the monetary easing. The Fed recognized that the US economy remains in good shape and slightly upgraded its assessment of personal consumption.

However, the hawkish forward guidance was unexpected by financial markets. The FOMC statement said the future path of Fed funds will be essentially data dependent, and reiterated its recent mantra: “will act as appropriate to sustain the expansion”. This was followed by a hawkish bias in Powell’s press conference, where he said the rate cut has an insurance and risk management aspect to it. He also stated that this easing is not the start of a long cutting cycle, but he kept the door open for another cut.

Our view prior to the FOMC decision was that market expectations of 100bp in rate cuts, which were priced into the market in early July, were too aggressive considering the healthy macroeconomic fundamentals of the US economy. The market has a tendency of pricing too much easing for rate cuts triggered largely by external events, while underpricing easing for domestic factors like recession. This time is no different, and the market is now reducing its rate cut expectations for the next six months.

We do not expect any more cuts this year. This is in contrast to the market, which expects two more cuts in 2019 and one cut in 2020. While it is a close call, we are not expecting any more Fed rate cuts this year as long as consumer spending does not materially weaken this year and next and risks (in particular related to the trade war) do not escalate further.

In view of the market’s unrealistically high rate cut expectations, we favored short duration fixed-income exposure ahead of the FOMC meeting. Ongoing worries about the weakness in global growth and uncertainty over US-China trade are weighing on global interest rates and in turn, US Treasury yields. We believe US Treasuries have priced in a lot of negative news and current valuations are not reflecting the relatively robust domestic fundamentals. We expect 10-year yields to stay in a range of 1.9%-2.4% between now and year-end. However, international trade issue remain the largest wildcard that could inject volatility into Treasury yields. As a result, we are cautious on US Treasuries and continue to prefer US fixed income securities that benefit from sound domestic fundamentals.

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