

# OCM Asset Management

## Discretionary Asset Managers | Stockbrokers

### **Market Update: 1<sup>st</sup> August 2019**

#### **The Fed cuts rates, but disappoints on guidance**

In line with market expectations, following the July FOMC (Federal Open Market Committee) meeting, the Fed announced last night it would be cutting interest rates amid global weakness and trade uncertainty in a bid to boost the US economy. While markets were expecting a dovish move from the Fed, the size of the cut and guidance on the potential for further cuts disappointed, limiting the effectiveness of the stimulus in financial markets.

The Fed announced yesterday it would be cutting interest rates by 25 basis points to 2.25%, representing its first cut since the 2008 financial crisis. Fed Chairman Powell described the move as a 'a mid-cycle adjustment' to get the economy going again, playing down the scope for further significant easing. This was met by disappointment in financial markets as participants expected a more dovish approach from the Fed, with economists dubbing the move a 'hawkish cut'. At the same time, the Fed announced it was ending the program to shrink its balance sheet on 1<sup>st</sup> August, two months earlier than planned, marking an end to the quantitative tightening program.

#### ***Expectations***

The Fed's decision to cut rates comes after months of mounting expectations for aggressive monetary policy easing, despite economic data which some economists have deemed as unsubstantive of a cut at this stage. Markets had been pricing in one, two and now three cuts going into the July Fed meeting, therefore Powell's signals that policy makers weren't convinced of the need for a full-fledged round of easing disappointed investors, as two committee members remained in favour of holding rates unchanged. At the same time, had Powell signalled the potential for deeper cuts in the future, this could have been negatively received in the market as there being more weakness in the economy than indicated in the current data, therefore Powell was tasked with a delicate balancing act.

President Trump has been a very vocal critic of the Fed in recent months, calling for an aggressive rate cut to boost the US economy, citing dollar strength as a key reason to reduce rates, thus making US goods and services more competitive. Following yesterday's announcement, he tweeted "As usual, Powell let us down" after the Chairman failed to back stronger easing. The President has been increasing pressure on the Fed since May, raising concerns about whether the Chairman could be removed by the President given the intended independence of the Federal Reserve from the government. The President had been calling for a 50 basis point cut as part of a lengthy and aggressive rate-cutting cycle to keep pace with other key powers across the world, which was certainly not delivered last night.

#### ***Why did the Fed cut?***

Chairman Powell's description of the cut as a 'mid-cycle adjustment' and not the start of a cutting cycle contradicted expectations of continued cuts over the remainder of 2019, however he did not

rule out further cutting later in the year. According to a statement from the FOMC, the cut comes “in light of the implications of global developments for the economic outlook as well as muted inflation pressures” as trade uncertainty resulted in companies delaying investments. The cut was designed to insure against downside risks in the US economy to counteract global weakness and tariff increases, however Powell remained upbeat about the economic outlook despite lacklustre economic data. The committee noted that it would continue to monitor the economic data for signs of further signs of economic weakness and act accordingly, which could mean further stimulus should economic conditions deteriorate further.

### **Market Reactions**

In reaction to the 25 basis point cut on Wednesday, financial markets appeared rattled, with market reactions not following traditional trends observed after previous rate cuts. This was predominantly down to current market and monetary conditions elsewhere across the globe. Key reactions were:

#### **Dollar Strength**

The dollar rallied on the back of the news, with the US Dollar Index which measures the currency against six major rivals rising 0.5% to a two-year high. A stronger dollar tightens financial conditions and puts pressure on US-based companies with overseas revenues. A stronger dollar also acts as a headwind for commodities and emerging markets.

The strength of the dollar is a particular concern for investors, who were hoping that cutting rates would result in a dollar weakness which would benefit the US economy. As other central banks are also easing, the rate cut is unlikely to have the desired effect.

#### **A Flatter Yield Curve**

In theory, a Fed rate cut should lead to a steeper yield curve, with higher yields on longer dated treasuries due to the expectation that growth and inflation will be boosted by stimulus, however this didn't happen, with the yield curve continuing to flatten, inflation expectations broadly unchanged and risk assets closing lower as the Fed disappointed on expectations for a more aggressive cut, and as the cut is unlikely to provide much of a boost to the US economy.

#### **Equity Market Decline**

US markets declined during the Fed press conference last night, with the Dow Jones closing down 1.2% while the S&P 500 declined by 1.1%, the largest intraday declines since late May. Stocks declined as Powell highlighted that the cut was not the start of a “lengthy” cycle of cuts, then trimmed back losses as he later clarified he wasn't saying it would be a one-time cut. Away from the US, European shares rose while most shares retreated in Asia on the back of the announcement.

#### **Weaker Gold Price**

Gold ended lower ahead of the Fed decision, extending losses as the dollar rallied in reaction to Powell's remarks, however with risks remaining in the global economy and with central banks expected to continue to deliver stimulus in coming months, putting pressure on bond yields, gold is expected to be favoured as investors go in search of yields.

### ***Is the cut expected to boost the US economy?***

This is the all-important question following last night's announcement, and the immediate market reactions suggest not. The key issues facing the US economy are uncertainty over trade policy and a currency which is too strong. In theory, rate cuts should help the dollar issue, however given that the other central banks including the ECB and the BoJ are also easing quickly (if not faster), it is likely that this will be ineffective in practice, with interest rate differentials remaining significant.

A key risk is that lower rates could lead to asset bubbles and excessive borrowing, with company indebtedness and personal indebtedness likely to continue to increase, creating risks to economic stability later down the line. Given the currently high levels of corporate and personal debt, this is a risk which should not be ignored.

Despite the disappointment in the magnitude of the easing action which resulted in a decline in equity markets, investors are likely to view the cut as signalling that the US economy is not significantly deteriorating. At the same time, any further deterioration in US economic data could now throw this logic out of the window. Our expectation is that given the continuing weakness of key players in the global economy, global growth will continue to weaken, with problems being exacerbated by extra US tariffs on Chinese imports and a worsening of global trade conflicts. This weakness is already beginning to feed through into reduced corporate profitability, with this earnings season showing significantly weaker earnings on average than in previous quarters which is expected to be reflected in equity valuations.

### ***Overall***

Given that the Fed rate cut appears not to have had the desired effect so far, it remains to be seen as to whether more cuts will solve the problems facing the US economy. In our view, the key risks facing the global economy remain, with economic weakness expected to continue to feed through as a result of trade uncertainty and decelerating growth. Corporate earnings weakness reveals the underlying health of US companies, and valuations are high given reduced profitability and lower full year expectations, with headwinds to global growth remaining. The economic data is deteriorating, and our thesis remains well supported, with downside risks increasing. Given persisting near-term weakness in the US economy and elsewhere across the globe, the Fed's rate cut has not caused our outlook or expectations to alter, and we remain defensively positioned.

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