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# Market Update: 31st October 2019

**The Fed Delivers a Halloween Treat to Equity Markets, while Bond Markets Forecast a Gloomy Outlook**

In line with investor expectations, the US Federal Reserve cut rates by another 25 basis points yesterday, in its third interest rate cut this year. In taking the action, the Fed cited "the implications of global developments for the economic outlook as well as muted inflation pressures", leading some analysts to conclude that recessionary concerns fuelled this most recent 'insurance cut'. At the same time, the Fed signalled that it does not expect to make further cuts unless the economic outlook changes materially.

***A Change in Tone***

In contrast to the June, July and September meetings, the committee changed its language in its statement on Wednesday following the two-day policy meeting, dropping its pledge to "act as appropriate to sustain the expansion", while adding a commitment to continue monitoring the data as it assesses the correct path for Fed policy. This suggests that the Fed is trying to guide the market not to expect more cuts for now.

Fed Chairman Powell reiterated the committee's view that policy is in a good place, stating that the current policy stance is likely to remain appropriate unless the data suggests a change in the outlook. As with the previous two cuts, the Federal Open Market Committee (FOMC) cited the implications of global developments in deciding to lower the target range to 1.5%-1.75%.

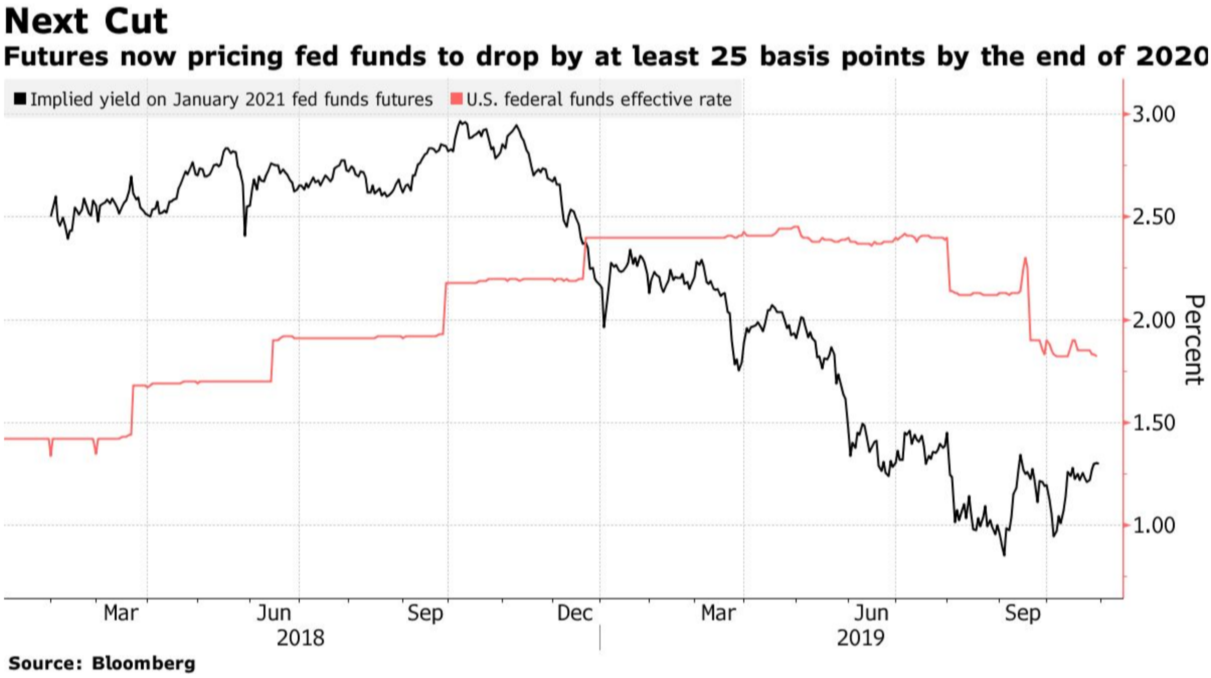
***Market Reaction***

The last two Fed rate cuts appeared to be ineffective in stimulating the economy, with equity markets falling on underwhelming future rate guidance while the dollar strengthened, which is not the desired effect of a rate cut. In reaction to the decision to cut rates for a third time, 10-year treasury yields fell, equities advanced and the US dollar gained. While continued dollar strength is likely to continue to constrain growth, a rally in equities indicated that the market had received the news positively. Bond markets took comfort in Powell's comments that there was a high bar to raising rates as inflation remains muted, with a significant move up in inflation required before considering increasing rates. Despite gaining yesterday following the announcement, it should be noted that equity markets are expected to close lower today based on a bleaker global economic outlook, with an end to the US-China trade conflict seeming increasingly far away.

***Rate Expectations***

While lower rates do little to combat the uncertain trade picture, it is hoped that the Fed's actions will prop up the US economy for longer, as recent data has begun to suggest that economic weakness may be feeding through into the jobs market and consumer spending, which have been the key driving forces behind US economic growth in 2019.

As a result of deteriorating economic data against a backdrop of cooling global growth and simmering trade friction, despite the Fed's assurances, the bond market isn't convinced that the Fed is done lowering rates. Markets abandoned expectations for a December rate cut after yesterday's statement, however data suggests that they do see another reduction by November 2020, leading yields on longer maturity Treasuries to fall over the trading session.




The Fed maintained a positive tone on the condition of the US economy; however it is likely that this was intended to soothe recessionary concerns. In reality, if the economy was as strong as the Fed suggested, the central bank would not have cut interest rates three times in the space of 4 months. The Fed commentary increases the focus on key US data in the coming weeks as investors try to define the Fed's path, with Friday's figures on the labour market and manufacturing expected to become key datapoints. A key concern is that weakness in manufacturing and faltering confidence in the business sector might threaten consumer spending, particularly if the job market continues to show signs of cooling. While this appears to have been overlooked by the equity market, the bond market's reaction to the most recent cut reflects a darker take on the economic outlook.

***Critics of the Rate Cut***

Although the rate cut was widely expected in markets, the FOMC was not in complete agreement in its October rate decision, with Kansas City Fed President Esther George and Boston's Eric Rosengren dissenting, preferring to leave rates unchanged. The two also dissented in the previous two decisions to cut rates in July and September, arguing that easing now uses important ammunition which may be required to combat a more serious downturn in the future.

On the other end of the spectrum, this week's Fed rate cut did little to pacify President Trump, who has repeatedly attacked policymakers for not doing enough to stimulate the economy given his increasingly protectionist trade policy amid slowing global growth. Earlier in the week, the President called on Powell to slash rates to zero, favouring negative rate strategies currently being pursued by central banks in Europe and Japan.

***October Bright Spots?***

Within yesterday's press conference, Chairman Powell referred to potential improvement in the trade war with China and reduced prospects of a no-deal Brexit, saying that things "look brighter than in late September", however this remains open to interpretation, with overall data continuing to suggest a bleak growth outlook. The US-China 'interim deal' appears to be less meaningful than first thought when we examine the details of the deal, and the calling of a general election in the UK means that the Brexit argument will continue to wage further into the last months of the year.

***Positioning***

The Fed's most recent rate cut did not come as a surprise, however the subsequent change in tone is important to note, with the central bank now not expected to cut rates further until well into next year. In our view, as current data suggests that the US economy is likely to deteriorate further in the near term, and with key risks such as trade and political uncertainty remaining, we expect that the Fed will be forced to cut earlier than guidance suggests, to the benefit of long duration US treasuries. In terms of the Fed's continued message on the strength of the US economy, this cut suggests that the Fed is becoming increasingly concerned about the US economy, with corporate earnings data now fuelling recessionary concerns and warranting the extra stimulus provided by a rate cut. As it stands, we remain defensively positioned and continue to expect a decline in equity markets as the economic weakness feeds into corporate valuations. In the coming weeks, key US data points to monitor closely will be consumer confidence, labour market conditions, and services data.