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ASK FORSTRONG:

MONETARY CLIMATE CHANGE

THE FED HAS CUT RATES. WHAT HAPPENS NEXT?

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Speed Read:

- This latest Fed rate cut is historic. Not only is it the first time in a decade that rates have been lowered but, also, it is the first time the Fed has dropped rates without clear evidence of a recession.
- The Fed is clearly deviating from its traditional playbook: it is now acting pre-emptively with interest rate cuts.
- Several other countries will follow the US's foray into more monetary stimulus. Emerging Asia in particular is primed for a policy easing cycle.
- Don't get caught in the gloom. From here, yield curves should steepen and duration should be kept short. Growth will actually accelerate, especially outside of the United States where policy easing will have a more dramatic effect. That means equity exposures should be moving internationally, including emerging markets.

The men and women that meet eight times a year to set the price of American money determined yesterday that it must be cheaper. The Fed funds rate was decreased by 25 basis points.

This latest move is historic. Not only is it the first time in a decade that rates have been lowered but, also, it is the first time the Fed has dropped rates without clear evidence of a recession. No economic data justified a cut.

Indeed, monetary climate change is swiftly underway. But what do investors need to know at this juncture? And what are the important signals coming from the central bank? To be sure, mystique is a well-developed art form at the Fed. Deciphering the text of central banker commentary is often akin to reading ancient hieroglyphics. But contrary to the impenetrable linguistic approach of his predecessors (ahem, Alan Greenspan), Jay Powell's plain-spoken style offered some guidance this week. More light was shone on the monetary path ahead.

For one, any institutionalized respect for the Phillips curve (which mumbles something about an inverse relationship between unemployment and inflation but nevertheless was the primary framework for understanding and forecasting inflation amongst policymakers) has now been dismantled. US unemployment is at a 49-year low while CPI inflation remaining above sea level for any sustainable period seems more elusive than ever. So much for any tradeoff there. Powell himself has admitted the relationship between inflation and jobless rates has broken down.

But a broader evolution in the Fed's approach is afoot. Consider that central banking has long been a confidence game. Once upon a time policymakers claimed a clear and panoramic view of what was to come. Increasingly since 2008, the investing public has not been convinced of their clairvoyance. And why should they be? The Fed's chronic misjudgments in the post-crisis period (consistently overestimating inflation and growth prospects) have been hard to ignore.

A new model was needed. Enter the so-called data dependent approach, where incoming data was scrutinized to determine any change in monetary positioning. In many ways, this shortened the Fed's time horizon. More damagingly however, it created far more volatility, introducing an internal risk whereby the Fed allowed themselves to get whipsawed by shorter term data.

All of that is history. Now the Fed has entered a more — whisper it — introspective period. A key focus of the Fed is their frustration with the variability of metrics Powell refers to as "celestial stars": the natural rate of unemployment, potential output growth and, especially, their estimate of the neutral interest rate. ""We're learning that interest rates, that the neutral interest rate, is lower than we had thought …" Powell recently lamented. "So monetary policy hasn't been as accommodative as we had thought."

Our team has written extensively on this topic. Several global undercurrents — mainly demographic and technological in nature — have all tugged global growth rates lower, especially in the developed world. That means a demand-deficient world will continue to require lower rates than in the past. (See "The Dangers of Stargazing" for more on this subject: https://www.forstrong.com/wp-content/uploads/2019/05/Ask-Tyler-05-03-2019.pdf).

It should not be a surprise then that the Fed is deviating from its traditional playbook: it is now acting pre-emptively with interest rate cuts. In Powell's words, "an ounce of prevention is worth more than a pound of cure." Not exactly elegant prose, but at least it's in plain English.

It's not just the Fed either. Almost all major central banks are terrified of making a policy mistake. This is a serious departure from the data-dependent style of recent years. But investors should expect more preemptive central bank activity.

Investment Implications

For now at least, America's money is the mainstay of the world's money. And the Fed has become a leading indicator of what other central banks will do. The period directly ahead should see several countries follow the US's foray into more monetary stimulus. Emerging Asia in particular is primed for a policy easing cycle. Central banks in Indonesia, Malaysia, Philippines, South Korea and India have all cut rates in recent months.

In general, this reflationary movement will be positive for risk assets. But Fed easing will also short-circuit the monstrous bond rally this year. Why? While it may seem rational to bet on lower yields in anticipation of interest rate cuts, the upturn in nominal growth over the coming months will be more than enough to offset the pressure on longer-dated yields exerted by short-term interest rates.

Plus, investors have already front run the widely-anticipated Fed cut. Bonds are now heavily overbought. Need evidence? Never mind the swelling amounts sunk into negative-yielding sovereign debt. Stand in wonder of the more freakish fixed income issues. For example, the Republic of Austria has just brought back its "century bond" — riddled with interest rate risk — at a whopping 1.2%.

Bond bulls are charging every other notorious corner of global debt markets too. July's survey of global fund managers (from Bank of America Merrill Lynch) reveals the most favoured asset class on planet earth: longer-dated US treasury bonds.

Don't get caught in the gloom. From here, yield curves should steepen and duration should be kept short. Growth will actually accelerate from here, especially outside of the United States where policy easing will have a more dramatic effect. That means equity exposures should be moving internationally, including emerging markets.

A quarter-point cut may not be the shock and awe investors, nor Donald Trump, were hoping for. Still, the monetary outlook is enough to once again gather round the punch bowl.