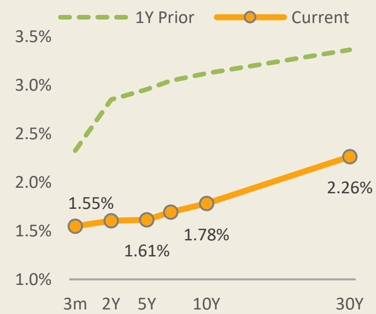
Need to Know

Portfolio Advisory Group – U.S. Fixed Income

October 30, 2019

Treasury Yield Curve



Source: RBC Wealth Management, Bloomberg

October FOMC Meeting: Is the third time the charm?

As widely expected, the Federal Reserve cut the Federal Funds target range by 25 basis points for the third consecutive meeting to a current target range of 1.50%-1.75%, a move aimed at protecting the U.S. economy from external risks of trade tariffs and a slowing global economy. Two Fed President's, Eric Rosengren and Esther George, dissented to the cut, voting instead to hold rates steady for the third consecutive meeting. The statement, along with the subsequent press conference from Chair Powell, indicate the Fed intends to remain on hold from adjusting interest rates as the current stance of monetary policy is consistent with the committee's current outlook for growth and inflation.

- **Statement highlights**: The statement showed a shift in Fed bias away from future rate cuts, a pivot from this summer when trade disputes threatened to derail the global economy. The statement acknowledged that business fixed investment and exports remain weak, but offset by a strong labor market and a low unemployment rate that has boosted household spending and kept the U.S. economy out of a recession thus far. The language removed a Fed pledge to "act as appropriate to sustain the expansion' and signaled more of a wait and see approach. Arguably, the Fed left the door open to further interest rate cuts as the Fed noted they will monitor incoming information as it 'assesses the appropriate path' of interest rates.

- **The Fed outlook.** Chair Powell did his best to persuade markets that further adjustments to monetary policy will only come if the committee sees a 'material reassessment' of the economic outlook, and reiterated that the three cuts thus far were to be viewed as insurance cuts against a slowing economy, and will take some time to work through the economy. The committee cited the strength of the U.S. consumer as well as the three main risks from abroad to the U.S. economy: the risk of an escalation of the trade war with China, a hard Brexit, and a sharp slowdown of global economic growth.

- **The next move hinges on inflation:** After Powell said, "*We're not thinking about raising rates right now, but there obviously will be times in the future*" he attempted to convey a more hawkish message in an attempt to push back against additional rate cuts by saying the committee believes the 'risks' to the economic outlook remain to the upside. With the unemployment rate at multi-decade lows, reporters pressed Powell on what it would take for the next policy to move to be a rate hike. His response, "*I think we would need to see a really significant move up in inflation that's persistent before we even consider raising rates to address inflation concerns."* Future measures of inflation continue to move lower, thus as far as a catalyst goes to reverse course, he continued to say that a resolution to the U.S. and China trade dispute would likely be needed to move the needle on inflation, as a resolution will reduce uncertainty which in turn will rekindle business investment that has collapsed since spring.

- **Our view:** Our concern is that the bar for further rate cuts is now higher, as some officials have previously stated that they would prefer to wait for signs of an actual economic downturn to cut rates further — given limited scope to do so. We believe that creates a bigger risk that the Fed falls behind the curve on a slowing economy. All told, we think that any pause will be short-lived, as further easing will likely be necessary as the economy continues to slow, pending any surprise trade resolution. Yield curves are flattening on the relatively-hawkish statement, and could continue to do so into the end of year if the Fed gets too aggressive in making the case for a pause.

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All values in U.S. dollars and priced as of 10/30/2019

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