Fed Watch

Rate cuts

Nordea Markets - Analysts
Anders Svendsen
+45 55471527
anders.svendsen@nordea.com

Kjetil Olsen
+47 22487788
kol@nordea.com

We change our Fed forecast, adding four rate cuts starting in July. Fed pricing has changed rapidly during the past month, and Fed Chair Jerome Powell recently opened the door for policy adjustments if needed, suggesting to us that rate cut discussions will take centre stage at the June FOMC meeting. While the first rate cut looks likely in July, the additional three rate cuts in our forecast hinge on our economic slowdown scenario materialising.

Why

There are three main reasons why we believe that rate cuts are now likely: 1) the escalation of the trade war; 2) markets' recession fears; and 3) the Fed's change in reaction function, with increased focus on too-low inflation and inflation expectations.

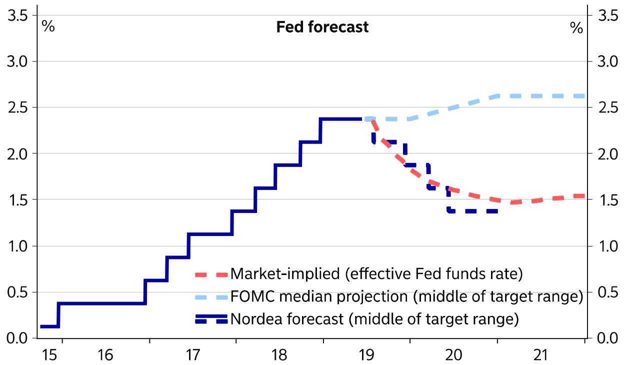
When

We expect rate cuts to be the major topic at the June FOMC meeting and the first rate cut could be delivered in July. Markets are currently pricing a three-in-four chance of a rate cut by July.

What

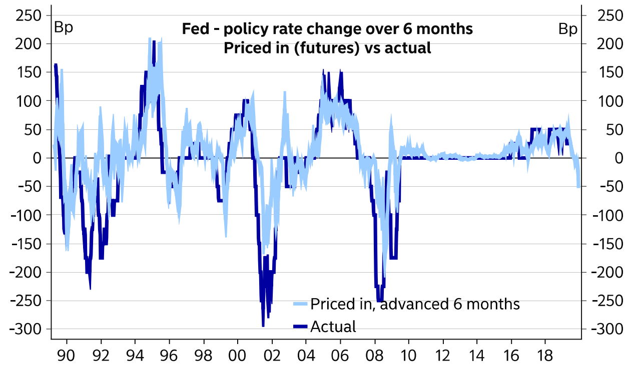
We expect the Fed to continue cutting rates at a quarterly pace until the economy shows signs of recovery, which in our forecast is towards the middle of 2020. Four rate cuts over the course of the next year is roughly in line with current market pricing.

NEW FED FORECAST



Source: Nordea and Macrobond

MARKETS DO NOT TEND TO OVERREACT



Source: Nordea and Macrobond

New Fed Forecast

Why, when and what...

Why

Economy still in a good place...

What has changed over the past month to justify this big change in the Fed views? In terms of actual numbers, not much to be honest: the US economy is still growing above its potential, with unemployment at a decades-low level and core inflation close to target. The manufacturing sector is slowing, but without clear signs of spillovers to the service sector yet. Nevertheless, we believe the Fed will cut rates soon for three reasons:

- Fear of further trade war escalation;
- Market fears of a recession; and,
- the Fed's focus on overly low inflation and inflation expectations.

...but uncertainty has increased with the escalation of the trade war

Uncertainty has increased quite a lot with the escalation of the trade war, which may hurt the economy down the line and has prompted immediate reactions in equity and credit markets.

The current situation bears some resemblance to the sharp tightening of financial conditions during the autumn of last year that prompted the Fed to end QT early and remove three rate hikes from the dot-plot within a few months without any significant weakening of economic key figures.

Equities are still some way from the lows from December 2018 but trending lower, while credit spreads are already close to the widest levels of last year.

The Fed has learned from the December 2018 experience, we think

In our view, additional tightening of financial conditions is bound to prompt Fed easing and there are plenty of reasons to expect lower equities ahead (see eg the latest Nordea View: Priced for perfection). Moreover, with four rate cuts already priced in, the Fed might very well fear prompting even tighter financial conditions in the event it fails to deliver the expected cuts.

FINANCIAL CONDITIONS TIGHTENING AS EQUITIES FALL AND CREDIT SPREADS WIDEN

Source: Nordea and Macrobond

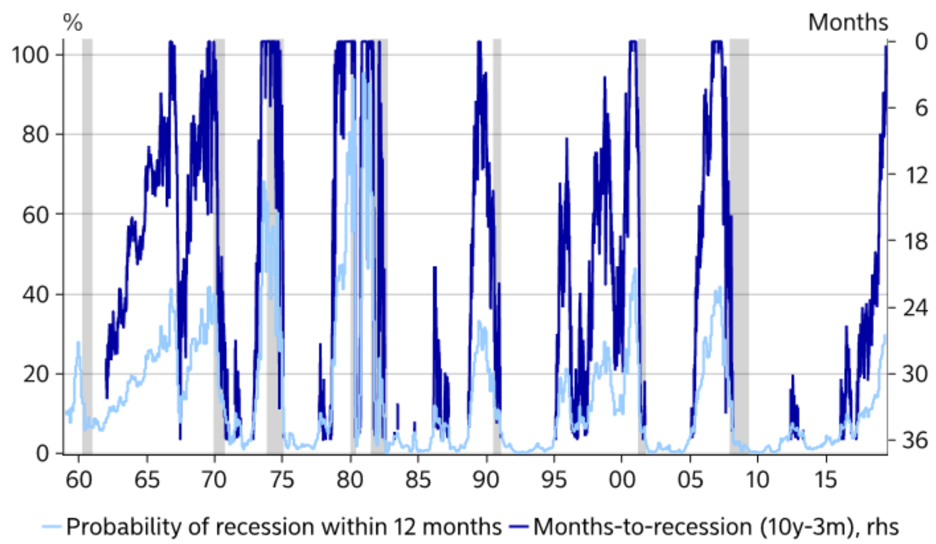
Markets fear a US recession

In the second factor supporting Fed rate cuts, the ever more inverted yield curve gives a strong signal of a recession ahead, for believers in the yield curve as a recession indicator, and at minimum it shows that markets fear a US recession. The average 10-year Treasury yield less 3-month T-bill rate at the onset of the last seven recessions has been minus 29 bp. At the lows of last week, it was 28 bp. Thus, our timing model says a recession is near and the New York Fed's standard probability model says that recession risks are rising to levels last seen in autumn 2006.

Fed fears sharply tightening financial conditions

We still believe a trigger is needed to prompt an outright recession, but sharply falling equities as well as sharply widening credit spreads could become such triggers (see Economic Outlook: The waiting game). The chances of this happening increases significantly, in our view, if the Fed does not deliver.

THE MARKET FEARS A RECESSION AHEAD, ACCORDING TO THE YIELD CURVE



Source: Nordea and Macrobond

Falling inflation expectations are an increasing concern to the Fed

The third factor is falling long-term inflation expectations, easily seen as waning credibility in the Fed's inflation target. Longer-term market-based inflation expectations have rarely been this low in the past. The Fed is increasingly concerned with the uphill battle it is facing on inflation and inflation expectations.

Inflation has been on the low side of the inflation target of 2% lately and has been lower than expected. While Governor Powell spent most of the last press conference in May explaining why the Fed views the recent drop in core inflation mostly as transitory, the Fed has become more concerned about overly low inflation lately.

We think, for instance, the dovish U-turn in January could partly reflect this changed focus on inflation. During the press conference in March, Fed Chair Powell was more vocal than ever: "So, what I see is inflation that's close to two percent but that sort of keeps bumping up against two percent and then maybe moving back down a little bit. And I don't feel that we have kind of convincingly achieved our two percent mandate in a symmetrical way."

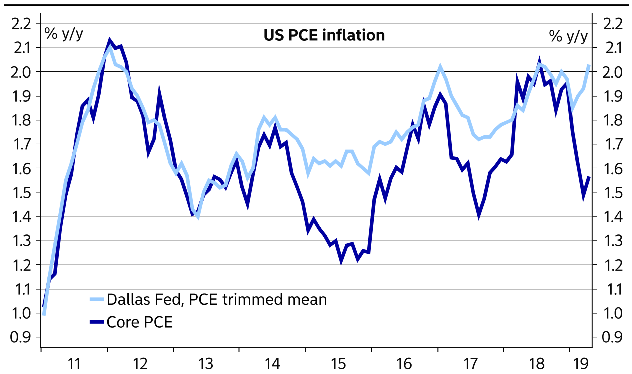
The Fed would prefer to overshoot

If anything, the FOMC would like inflation to overshoot the 2% target to make sure inflation expectations firmly anchor around the target. The likelihood of this happening decreases if the economy slows too fast. Given the increased uncertainty discussed above, the Fed might want to reduce rates to be on the safe side.

MARKET-BASED INFLATION EXPECTATIONS FALLING

Source: Nordea and Macrobond

TRANSITORY FACTORS



Source: Nordea and Macrobond

When

Reasons for a pre-emptive rate cut in place

Falling longer-term inflation expectations and tighter financial conditions due to the trade war and recession fears are all reasons to act pre-emptively. However, the markets are doing the Fed's job for it in the sense that four rate cuts have already been priced in. Now, the Fed must deliver, though it is not very pressured on time.

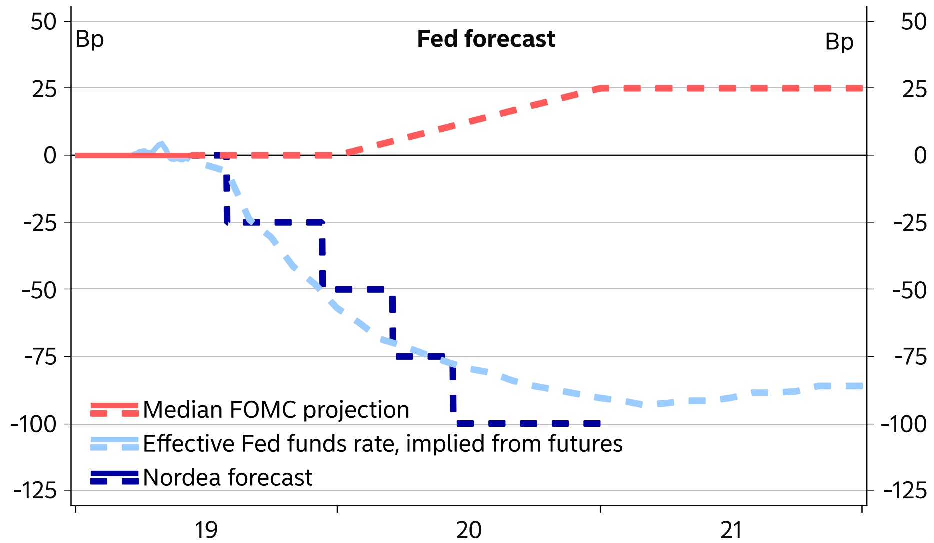
Discussion in June, cut in July

We expect rate cuts to be a major topic of discussion at the June FOMC meeting, but delivery is more likely in July. Markets are pricing in around a three-in-four probability of a rate cut by July.

The dot-plot is probably a key concern for the June meeting. If individual members are not adding their inclination to cut rates to the dot-plot, Chair Powell may have a hard time selling the "rate cuts are coming"-story at the press conference.

However, we believe the Fed learned from its experience during autumn and will deliver what the markets want out of fear of triggering another December 2018. Increased downside risks due to the trade war, as well as falling inflation expectations, will not make the argument difficult.

FED FORECAST VS MARKET PRICING

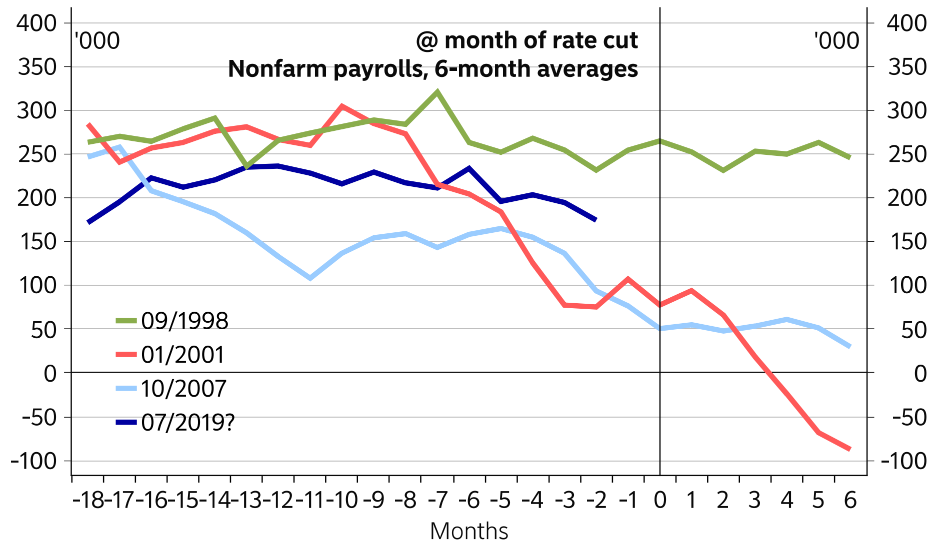


Source: Nordea and Macrobond

The Fed has had no problem cutting rates for the first time with trend payrolls at current levels. A first cut in July would be business as usual if payrolls continue to trend lower over the next few months.

The Fed has cut before with payrolls trend at current level

THE LABOUR MARKET IS NOT TOO STRONG FOR RATE CUTS



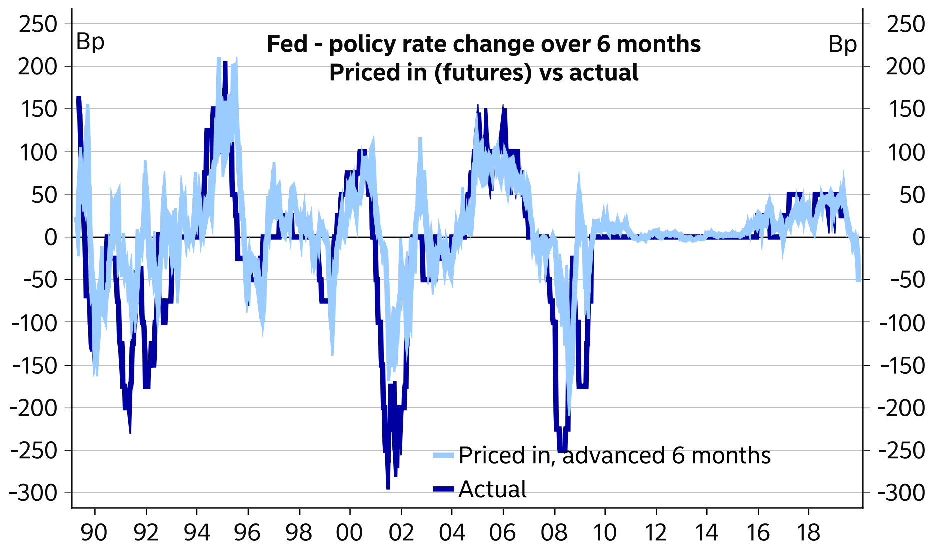
Source: Nordea and Macrobond

What to expect

One view when seeing the speed at which markets have gone from pricing in two rate cuts to pricing in four could be that markets tend to overreact. History does not support that view, though. In fact, markets tend neither to price in rate cuts too early nor to price in too many rate cuts compared with what the Fed ends up delivering.

Markets tend to price in the timing and number of rate cuts correctly

MARKETS DO NOT TEND TO OVERREACT



Source: Nordea and Macrobond

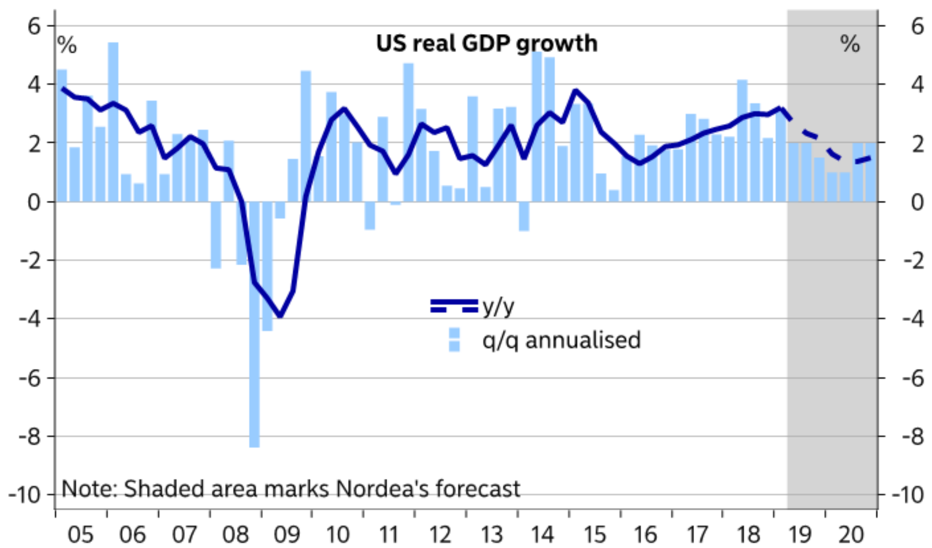
Rate cuts now could extend the expansion a while longer

The St Louis Fed's Bullard compares the current situation with the mid-90s, when after a cumulative 300 bp in rate hikes, the Fed cut rates by 75 bp and managed to fend off a recession, thereby extending the expansion to the end of the 90s. This time, the Fed has hiked by a cumulative 225 bp, though additional tightening has come from the normalisation of the balance sheet. Acting pre-emptively could – in Bullard's comparison – prevent a recession and extend the current expansion a while longer.

At a quarterly pace, the Fed will have delivered four rate cuts before a recovery is in sight

However, it is safe to say that the number of rate cuts in the upcoming cycle is still uncertain at this point. We expect a slowdown to gather speed in the second half of this year and to reach the weakest growth numbers in the first half of next year. If that scenario materialises, it is unlikely that the Fed will stop cutting rates before the middle of next year, by which time we believe a recovery should be visible on the horizon. At a quarterly pace, the Fed would then have delivered four rate cuts.

GROWTH FORECAST



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Nordea Bank Abp, Satamaradankatu 5, FI-00020 NORDEA, Finland, domicile Helsinki, Business ID 2858394-9

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