GENERALI INVESTMENTS

GIAM Macro & Market Research - Market Commentary

The Fed to cut rates two more times by the end of the year

- **The tone and substance of the press conference after the July 31st meeting showed that the Fed is getting more concerned about the global economy and trade uncertainties, which have intensified over the last days.**
- **This and the deterioration shown by the latest economic indicators lead us to update our Fed call. We keep continue to expect another 25 bps cut in September but bring forward to Q4 the final 25 bps cut we projected for the beginning of 2020.**
- **A cut at the December meeting still seems more likely than one in October, as it would come in conjunction with a new set projections. Risks remain tilted to bolder accommodation, though.**

The 25 bps cut in the fed fund rate decided on July 31st had two main rationales:

- First of all easying would serve as a sort of insurance policy against the risks coming from the global economy to an otherwise decent growth outlook
- Secondly, it would counter the persistent headwinds to inflation.

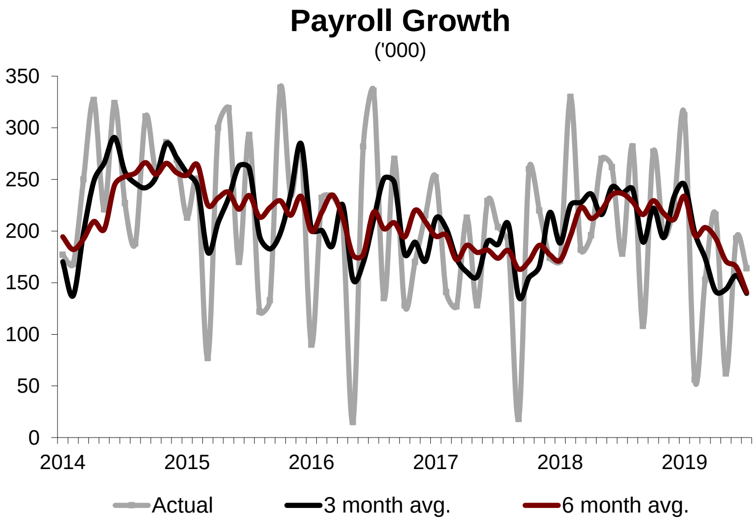
In the end the tone and substance of the press conference and the fact that two dissenting voting members preferred to keep rates unchanged, gave the meeting a more hawkish twist than expected. A cut in September still remains our base case and is widely expected by markets, but the Fed's tone has raised questions whether would stop easing thereafter.

In our view, the development since the July meeting will force the Fed to act more preemptively. Therefore we now bring forward to Q4 the third rate cut of the "mid-cycle adjustment in policy" we expected for the first months of 2020.

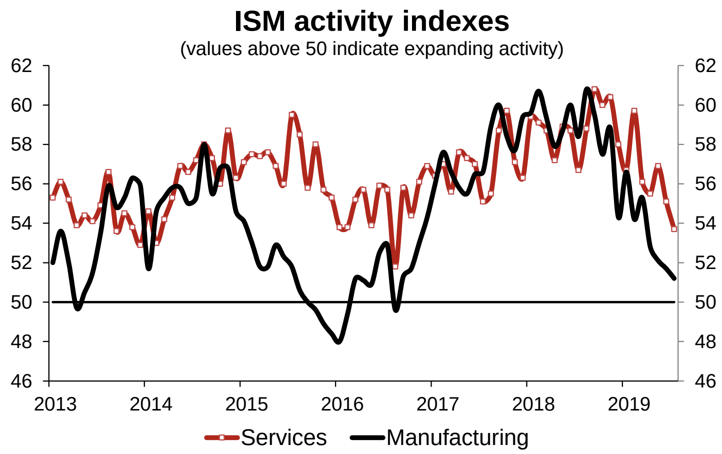
The main reason for this change is clearly the escalation of the trade tensions between the US and China. Trump has threatened to levy a 10% tariff on the around US$ 300bn of Chinese goods so far spared by restrictions and announced to label China as a currency manipulator. The decision to target directly imported consumer goods, ignoring the effect this will have on household purchases, is a game changer and bodes ill for a swift and positive outcome of the talks with Beijing. The sour mood is reinforced by the determination shown by the Chinese government, which planned to retaliate by stopping the purchase of US agricultural products.

It may well be that some of the threats (including the one of forcing a depreciation of the USD) will not materialize, but we think that most of the damage is done in terms of another unwelcome increase in policy uncertainty. This will be particularly bad for capex, whose weakness continued in Q2. Easier monetary conditions may help a bit in at least to avoid a quicker slide in investment.

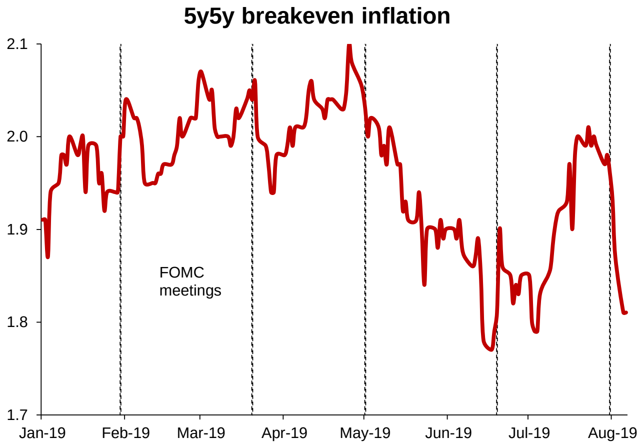
Secondly, data released after the meeting highlighted the slowdown of the economy. First of all the July employment report showed that job creation continues to cool down, while the peaking of wage growth was confirmed by the employment cost index (a less volatile series than the hourly earnings one), which increased by 2.9% yoy in Q2, against 3.0% in Q1 and 3.1% in q4 2018.



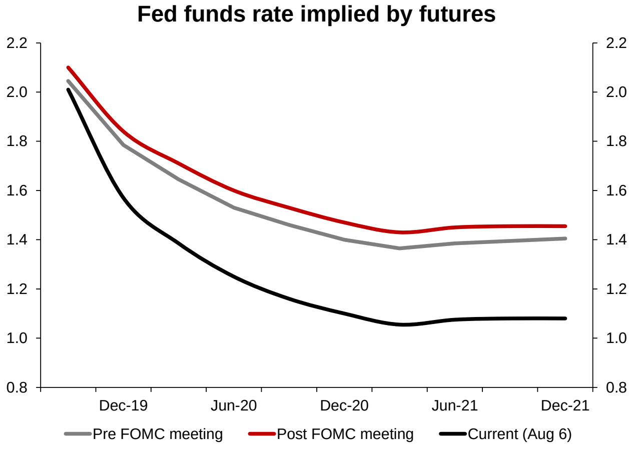
Moreover the ISM indexes continue to slide, reaching levels last seen in autumn 2016, for both manufacturing and services, with the new order components faring particularly badly The subdued performance of the service sector is particularly worrisome as it runs counter the expectation of a strong consumer sector offsetting the weak performance of investment and export.



Finally, looking at breakeven rates, the dovish twist by the Fed has not done much so far to uplift durably expected inflation. Actually, the 5y5y breakeven collapsed after the July 31st meeting, also reflecting the change in risk premia related to higher uncertainty on growth.



Financial markets have quickly revised their Fed outlook, and they now price more than 100 bps of further rate cuts (on top of the 25 bps expected in September) by the end of 2020. Such a cut would be needed only if the economy were clearly facing a recession. This which is not our baseline (thoughwe see a 30% probability of a recession within twelve months), and therefore markets might be in for a disappointment.



In terms of timing, we give a move in December higher odds than one in October (70% to 30%, conditional on a Sept. move). By that time the Fed will have more information on trade tensions., Furthermore, the cut in rates, which we think will be the last one of the cycle, will be accompanied by a new set of economic projections then. We see the July move (a cut with no new projections) as an outlier motivated by gradual shift in views by the FOMC members, and we think the Fed will prefer to provide as much background information as possible when it acts on rates.

Risks remain tilted towards bolder moves by the Fed, as uncertainty on trade policy will linger for at least several months.

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