LIKE A GOOD NEIGHBOUR THE FED IS THERE

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At last, the July Federal Open Market Committee (FOMC) meeting has come and gone, and the Federal Reserve (Fed) has done what was widely expected—it cut the federal funds target range by a quarter point. The Fed also announced they would be ending their balance sheet reductions in August, two months earlier than previously indicated. With all the Fedspeak, changing market expectations and the recent rebound in the jobs report, the time had come for the policy makers to put an end to the conjecture. While this decrease, of 25 basis points (bps), does fit into the Fed's "insurance policy" narrative, it still leaves open the question of what the future may hold.

Let's get right to that point, shall we? Unlike the June FOMC meeting, this gathering was limited to the usual policy statement and Chair Powell's presser. In other words, there were no blue dots (the Fed's own fed funds forecasts) this time around. The policy statement, which is what the Fed views as its official policy stance, was little changed from the June meeting including the key phrase "will act as appropriate," leaving the door open for additional accommodation this year. In fact, since the 50-bps-rate-cut crowd is somewhat disappointed by the July results, the focus has now shifted to another reduction in fed funds at the September 17th –18th FOMC meeting.

Remember, this rate cut was really not predicated on the Fed's baseline outlook for the U.S. economy; it was the voting members' way of trying to counter any potential negative impacts from trade uncertainty and slowing global growth. With no pushback from the Fed, the money and bond markets had boxed the policy makers into a corner. Despite the fact that U.S. financial conditions were actually easier prior to this meeting than when the Fed started raising rates at the end of 2015, there was concern that without a rate cut, conditions could have tightened. So, while you could say the Fed is back in 'data-dependent' mode, it appears as if monetary policy is still leaning towards another rate cut this year.

Conclusion

Ahead of the FOMC meeting, Fed funds futures were looking for a 100bp in total rate cuts by the end of 2020. This is where things could get tricky for the Treasury (UST) market. While we can see another 25-bps decrease later this year, as an extension to today's "insurance policy" move, our base case outlook does not foresee an additional 50-bps worth of rate cuts. In other words, the money and bond markets have already priced in a lot of good news on the rate front, so it would seem the UST market's "disappointment quotient" is on the elevated side, especially if the Fed only delivers half the rate cuts that are currently expected.

Unless otherwise stated, data source is Bloomberg, as of July 26, 2019.

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