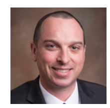
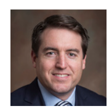
Will the Fed Pause End With a Rate Cut?

History shows that the Federal Reserve's next move is likely to be an interest rate cut.

March 2019



Stephen Bartolini, CFA
Lead Portfolio Manager for U.S. Core Bond Strategies



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KEY INSIGHTS

- In Federal Reserve tightening cycles from 1977 through 2006, a pause in rate hikes of longer than six months always led to a rate cut, not more increases.
- Our view is that the Fed will remain on hold at least until July, and history leads us to think that the central bank's next move will be a rate cut.
- We are positioning our U.S. core and total return portfolios for a steeper yield curve caused by a rally in short-term Treasuries on rate cut expectations.

During Federal Reserve tightening cycles from 1977 through 2006, a pause in rate hikes of longer than six months always led to a rate cut, not more increases. Our view is that the Fed will remain on hold at least until July, so this historical perspective leads us to anticipate that the central bank's next move will be a cut in interest rates. The inverted Eurodollar futures curve adds to our conviction in this outlook. As a result, we are positioning our U.S. core and total return portfolios for a steepening in the yield curve caused by a rally in short-term Treasuries on rate cut expectations.

Fed Pause Likely To Last Until At Least July

A key assumption underlying our outlook for U.S. monetary policy is that the Fed will keep rates steady through June, with the first potential change coming at the Federal Open Market Committee (FOMC) meeting in late July. The central bank has clearly pivoted to a dovish stance in early 2019, removing language about expecting further increases in the federal funds rate target range from the statement following the January FOMC meeting. Fed policymakers have communicated that they intend to carefully monitor incoming economic data for a period of time before changing the fed funds rate and implied that a rate move could be in either direction. Some of the leading economic indicators that we follow, such as purchasing managers indexes, indicate continued weakness in the months ahead.

If the Fed adjusts rates in July, it would end a seven-month pause since the December 2018 rate hike. From 1977 to 2006, the central bank's next move after a pause of seven months or longer in rate hiking cycles was a rate cut as opposed to a resumption in hikes.

> ...we think that a meaningful acceleration in global growth is unlikely, boosting our conviction in positioning for a steeper yield curve.

Fed Balance Sheet Was Still Expanding In 2016

We acknowledge that there was a 12-month break between the Fed's December 2015 rate increase—its first since the global financial crisis—and its 25-basis-point hike the following December. However, the central bank was still expanding its balance sheet during that time period, so there was an extreme amount of monetary stimulus in the system despite the gradual rate increases. The Fed did not begin to slow the reinvestment of proceeds from its holdings of Treasuries and mortgage-backed securities until October 2017, gradually winding down its balance sheet. (For more information on how the current environment differs from 2016, please see our recent Fixed Income Insights article Will Recent Credit Market History Repeat?)

Inverted Eurodollar Futures Curve

We also monitor the Eurodollar futures market, which measures market expectations for three-month deposit rates at specific future dates, to inform our outlook. The Eurodollar futures curve inverted in December 2018 as the rate on contracts expiring 12 months ahead priced in lower short-term rates than the current quarterly contract. Inversions in the Eurodollar futures curve have historically always preceded Fed rate cuts, so the current shape of the curve adds to our conviction that the next move from the central bank will be to lower the federal funds rate.

Positioned For Steeper Yield Curve

Taking these factors into consideration, we are positioning our domestic core and total return bond portfolios to benefit from a steepening in the Treasury yield curve by holding overweight positions toward the front of the curve. We anticipate that evolving market expectations for a Fed rate cut will cause shorter-maturity Treasuries to rally, decreasing their yields and increasing the difference in yield between short- and long-term maturities.

The main risk that would cause the market to move against this positioning is a substantial acceleration in global growth, which could happen if China implements unexpectedly massive stimulus measures to prevent an abrupt slowdown in the country's expansion. The resulting reduction in global macro concerns and increased inflationary impulses would likely force the Fed to raise rates, flattening the Treasury yield curve. However, we think that a meaningful acceleration in global growth is unlikely, boosting our conviction in positioning for a steeper yield curve.

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