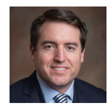
The Fed's Stealth Rate Cut

We are modestly adding risk in looser financial conditions.

May 2019



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KEY INSIGHTS

- The Federal Reserve's abrupt dovish turn has resulted in meaningfully looser financial conditions, providing the benefits of a rate cut without the central bank actually cutting rates.
- It is a possibility that the Fed's dovish pivot will extend the economic cycle, delaying the onset of the next recession, although much will depend on effective communication from the Fed going forward.
- In response to this more positive economic environment, we modestly added exposure to credit risk and inflation breakevens, but our overall positioning remains cautious.

The Federal Reserve's abrupt turn in early 2019 toward a dovish monetary policy stance has resulted in meaningfully looser financial conditions, providing the benefits of a rate cut without the central bank actually cutting rates. In fact, the Fed may have succeeded in extending the economic cycle. With the next recession now looking further off than it did at the beginning of the year, we modestly added to our exposure to risk assets—including bank loans—and Treasury inflation-protected securities (TIPS) in our Total Return Bond strategy.

Credit Spreads Surprisingly Resilient Amid March Rate Volatility

In late March, very poor German manufacturing data triggered a pickup in volatility in Treasuries. Investors seemed to become concerned that the Fed's dovish pivot was too late to stave off a global economic downturn, causing a rally in safe-haven government debt. The yield on the 10-year U.S. Treasury note quickly decreased by almost 40 basis points[1] from the highs at the beginning of March, reaching 2.37% near month-end before increasing slightly.

Ordinarily, we would expect credit spreads[2] to widen meaningfully in this type

[1] A basis point is 0.01 percentage points.
[2] Credit spreads measure the additional yield that investors demand for holding a bond with credit risk over a similar-maturity, high-quality government security.

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of environment, but high yield spreads moved less than they typically would. A simple regression analysis[3] of the reaction of high yield option-adjusted spreads (OAS) to changes in the 10-year Treasury yield over the past year implies that the type of rally in Treasury yields that we saw in March would ordinarily result in 50 to 60 basis points of OAS widening—but the actual OAS move in March was only 26 basis points.

Looser Financial Conditions

The combination of meaningfully lower yields on high-quality government bonds and the strong first-quarter rally in credit and equity markets has resulted in financial conditions that are considerably looser than at the end of 2018. This magnitude of loosening in financial conditions could be viewed as consistent with a central bank rate cut, but it appears that the Fed has delivered the benefits of monetary easing without actually cutting interest rates.

It is a possibility that the Fed's dovish pivot will extend the economic cycle, delaying the onset of the next recession. We are now less concerned about a recession beginning in late 2019 than we were at the start of the year. In fact, we have recently begun to see signs of renewed economic strength in the U.S. and China. The U.S. job market, in particular, is healthy, with weekly claims for unemployment benefits having declined for five consecutive weeks in mid-April. A strong labor market, combined with lower mortgage rates that are the result of the March Treasury rally, should support the housing market and consumer spending. China's gross domestic product expanded at a surprisingly strong 6.4% annual rate in the first quarter of 2019 as stimulus efforts appear to be gaining some traction. However, we do not expect a return to rapid growth—instead, we think that the probability of the economy staying in a "slow grind" expansion has increased.

Added Exposure to Credit Risk, Inflation Breakevens

In response to this more positive economic environment, we modestly added exposure to risk in various forms in our Total Return Bond portfolio. We removed some hedges against widening credit spreads. We also added to our allocation to bank loans, which currently offer yields that are nearly equal to those on high yield bonds. Because loans are higher in the capital structure, giving them repayment priority over bonds in a corporate bankruptcy, loans typically offer lower yields than noninvestment-grade bonds. Generally solid fundamentals and low default expectations should also support the bank loan market.

Looking at the longer term, we added TIPS amid Fed officials' statements about potentially allowing inflation to occasionally overshoot the central bank's 2% target to make up for periods of below-target inflation. While implementing this change in inflation-targeting policy is likely to take time, we think that Fed policymakers are serious about making the adjustment, which makes TIPS look attractive with the market currently pricing in inflation of less than 2%.

Overall Positioning Still Cautious

Despite this modest additional exposure to credit risk and inflation breakevens, our overall positioning remains cautious. As credit markets continue to rally and valuations become increasingly less attractive, it is difficult to argue that there is material upside potential from additional spread tightening. We are aware that another significant downward turn in economic data in

[3] T. Rowe Price analysis of Bloomberg data.

the U.S. or China could result in a quick sell-off in credit and a collapse in inflation expectations.

Also, Fed messaging going forward will be key—following the April 30–May 1 Fed policy meeting, Chairman Jerome Powell made statements that the market interpreted as hawkish, dampening expectations for an actual rate cut this year. This may have been unintentional, but it reinforces the need for clear, unambiguous communication from the central bank. In any case, we think that the Total Return Bond strategy is well positioned for a slow grind expansion following the Fed's stealth rate cut, and it has the flexibility to quickly adjust as conditions change.

WHAT WE'RE WATCHING NEXT

Although Chinese growth was unexpectedly strong in the first quarter of 2019, T. Rowe Price's sovereign credit analysts and economists are monitoring signals from China's government about how it will manage its stimulus programs going forward. There is some concern in the market that the surprising first-quarter GDP number will encourage the government to scale back its monetary and fiscal measures designed to boost the economy. However, with this year marking the 70th anniversary of Communist Party rule in China, the authorities in Beijing are under pressure to support growth.

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