

CENTRAL BANKS TO THE RESCUE AGAIN?

What the next round of monetary policy changes mean for investors

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KEY POINTS

- Global growth is slowing, manufacturing activity is weakening, and inflation continues to be stubbornly low.
- Despite low risk of recession in the short term, central banks are talking about interest rate cuts to support the economy.
With the direction of markets uncertain, we are modestly underweight equities, selectively holding risk assets that provide higher yield.

CHANGE OF DIRECTION FOR THE US FED

For much of the past decade, investors have experienced the longest period of economic expansion combined with one of longest equity bull runs on record. During that time, US real gross domestic product (GDP) grew by nearly 25%, while the S&P 500 Index went up by approximately 300%*. For all intents and purposes, we see little evidence that this cycle will end any time soon. Indeed, even though interest rates in several developed markets have increased in the past two years, for the most part we continue to see favourable conditions for markets: low interest rates, benign inflation, low unemployment, and no clear imbalances in the system.

Nevertheless, central banks are now moving to support the economy, whether through statements or interest rate cuts. The US Federal Reserve (Fed) signalled the potential beginning of a new interest rate cycle at the end of July or a pause of raising rates when it cut the Federal Funds Rate by 25 basis points to a range of 2% to 2.25%. To illustrate just how quickly things can change, it was only a few months ago when the Fed was talking about hiking rates. Perhaps even more remarkable is that the European Central Bank is also beginning to consider rate cuts even though its current deposit rate is -0.4%, while the Bank of Japan has mooted rate cuts despite its benchmark rate standing at 0%.

The question, then, is what has changed?

While most economies are not expecting a recession in the near term, we are aware that the risk of recession has been increasing. As the cycle extends further, by definition we move closer to a recession with each passing day. However, the length of a cycle is not a sufficient sole reason for it to end. Nevertheless, there are clearly risks on the horizon, and central banks are beginning to grow concerned about the health of the global economy. Not only does inflation continue to sit at stubbornly low levels, but policymakers are also grappling with a slowing global economy, weaker economic data, and the potential negative fallout from international trade tensions – not to mention a possible messy Brexit.

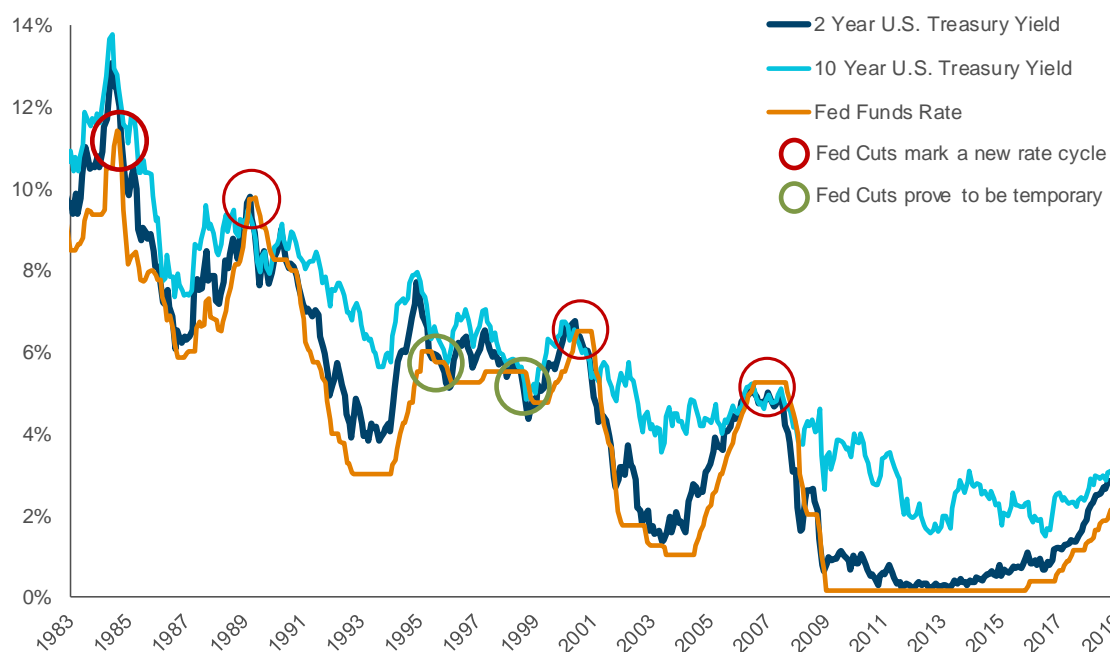
*Sources: T. Rowe Price analysis using data from FactSet Research Systems Inc. All rights reserved, S&P. See Additional Disclosures in Appendix.

As the world's major central banks begin to potentially shift to a round of interest rate cuts, it might cause bond yields to fall further, pushing up their prices. This will likely be supportive of risk assets because it will send investors in pursuit of the higher returns that are available in equity markets, high-yield corporate debt and emerging market debt. However, bond yields falling too steeply might have the opposite effect, as they might send worrying signals of an economic slowdown, spooking investors. Low rates are good, but too low rates might be bad.

FIXED INCOME RATES ARE SHIFTING LOWER

FED FUNDS VS. 2 TO 10 YEAR TREASURY YIELDS

January 1983 to June 2019



Source: Federal Reserve Board/Haver Analytics.

OUR POSITIONING

As central banks possibly shift into a new phase of rate cuts, this emphasises the importance of being diversified globally across fixed income markets. Bond yields move in the opposite direction to bond prices, so if interest rates drop, investors will see the value of their fixed income holdings rise.

While lower interest rates may benefit risk assets such as equities, high-yield corporate debt and emerging market debt, there are still question marks hanging over where the market will go from here. Growth is slowing, manufacturing activity has been weakening, and trade tensions and other geopolitical issues – such as Brexit – continue to linger. There is still room for equities to perform, although the strong rally we saw at the beginning of this year means, in our view, that they are currently sitting at higher valuations.

With that in mind, we are modestly underweight equities, preferring investments in growth equity as opposed to value, and we also like emerging markets. In fixed income, we believe there are attractive opportunities in emerging market debt and high yield markets because investors may support these assets as they seek yield. Overall, we believe now is the time to invest in areas that provide growth in a low-growth environment.

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