



There's Only One Way Out of Here

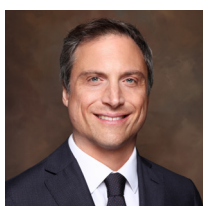
Will the Fed listen to the market and slash interest rates?

September 2019

The global economy is in a tricky spot. Its two biggest players, the U.S. and China, are engaged in an on-again, off-again trade war that is slowing growth in both economies, aided by the lingering impact of past policy tightening. The latest U.S. purchasing managers' index data were arguably the worst in 10 years (due to the softness in confidence and new orders), and growth in the eurozone has been sluggish for 18 months. A positive feedback loop is being formed between lower growth and weaker confidence, amplifying both.

In July, the U.S. Federal Reserve (Fed) cut rates for the first time in more than a decade. Since then, the U.S. yield curve has become flatter (and some portions, e.g., the spread between three-month and seven-year Treasuries, are now significantly negative), high yield spreads have widened, and equities have performed poorly. The markets are emphatically telling the Fed that a short, limited cutting cycle is insufficient to turn around growth. So much for refreshing the economic cycle.

The problem is that when it comes to boosting global growth, all roads lead back to the Fed. To put it bluntly, no other entity has both the willingness and the ability to stimulate the global economy. China is implementing some stimulus, but it is targeted and aimed



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at stabilizing domestic growth—there is no appetite in Beijing for another credit boom that would threaten financial stability. The Bank of Japan went “all in” three years ago. The European Central Bank has very limited scope for further stimulus. We may eventually get some fiscal stimulus in Europe, but not soon: There is little enthusiasm among the eurozone's biggest governments to increase debt.

The experience of recent times suggests that the major economies only grow at reasonable rates when stimulus is applied, so the absence of any obvious candidate—other than the Fed—to apply that stimulus is an issue. It seems likely that growth and inflation will continue to trend down until policymakers respond. A deep slowdown or minor recession feels inevitable. That said, a long and/or deep recession is unlikely because the economic imbalances required to cause it are simply not there.

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What happens next? Money markets are pricing in two possible scenarios, with two very different outcomes: First, a high probability of limited Fed easing, most likely comprising two more cuts. This would not be enough to kick-start global growth. Second, a low probability of significant Fed easing, resulting in rates being cut close to zero. This—combined with some limited fiscal stimulus from Europe and China—would be enough to refresh global growth.

Will the Fed get the message? And if so, when? The situation will probably need to get worse before it does. As such, it makes sense to remain long high-quality duration and maintain risk hedges. Eventually, though, history suggests that the Fed will do what it needs to do—and when that happens, it will present a great buying opportunity for corporate credit.

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