



# Fed Policy Transitions From Harmful to Helpful

The Federal Reserve has positioned the economy for reflation.

November 2019

## KEY INSIGHTS

- The Fed has shifted its monetary policy from harmful to helpful, loosening financial conditions, which should set up the economy for a period of reflation.
- We believe that the Fed will keep rates on hold for the foreseeable future as it has provided a credible policy response after overtightening in 2018.
- In this environment, we have positioned the New Income Fund to seek to benefit from a steeper yield curve and higher Treasury yields.

The Federal Reserve (Fed) has shifted its monetary policy from harmful to helpful, in our view, loosening financial conditions, which should set up the U.S. economy for a period of reflation. We believe that the Fed will keep rates on hold for the foreseeable future. In this environment, we have positioned the New Income Fund to seek to benefit from a steeper yield curve and higher Treasury yields, and we see opportunities in cyclically aligned investment-grade corporate bonds and Treasury inflation protected securities (TIPS).

## Initial Doubts About Fed Policy Moves

In our March Fixed Income Insights (“Will the Fed Pause End With a Rate Cut?”), we wrote that the Fed’s pause in rate hikes was likely to end with a cut, not more hikes. Indeed, on July 31, 2019, the central bank announced that it would reduce the federal funds target

rate range by 25 basis points.<sup>1</sup> In August (“Fed Did Not MOVE Enough, Bond Index Suggests”), we said that the Fed’s initial rate cut was probably the start of an extended easing cycle and not one of only a few “insurance cuts” that would stave off a near-term recession.

However, we also said that the Fed could still potentially succeed in loosening financial conditions and engineering a true midcycle adjustment (as Fed Chair Jerome Powell characterized the easing) if it acted with conviction to change the hawkish narrative stemming from its 2018 rate hikes and balance sheet reduction. In addition to the Fed becoming notably more dovish, we wrote that the U.S.-China trade conflict would need to de-escalate to some degree to support a recovery in growth.



**Stephen Bartolini, CFA**

*Lead Portfolio Manager for T. Rowe Price New Income Fund*



**Michael Sewell, CFA**

*Associate Portfolio Manager for U.S. Taxable Fixed Income*

<sup>1</sup> A basis point is 0.01 percentage point.

“We think that the turning point in the central bank’s policy stance was its decision in mid-October to commit to expanding its balance sheet...”

### **Fed Succeeds in Changing the Hawkish Narrative**

The Fed has indeed provided a credible policy response after overtightening in 2018. We think that the turning point in the central bank’s policy stance was its decision in mid-October to commit to expanding its balance sheet by purchasing USD 60 billion of Treasury bills per month until at least the second quarter of 2020. The Fed’s implementation of a repurchase<sup>2</sup> program, even if temporary, combined with renewed expansion of the balance sheet, addresses volatility in the overnight funding markets that has appeared periodically over the past year. Additionally, three rate cuts over the past four months have provided sufficient, and needed, accommodation to an economy reacting to both tight monetary conditions and tightening fiscal policies via trade tariffs. As of this writing in mid-November, pressure from trade tariffs is moving lower, albeit slowly, with a “phase one” trade deal coming into view.

In late August, real (inflation-adjusted) Treasury yields began rising from their lows. Real yields typically increase when the Fed is raising rates, so this was unusual in an environment of rate cuts. In conjunction with a stabilization in broader financial conditions, this was an early sign that the Fed’s easing was working and that the monetary accommodation would be part of a midcycle adjustment rather than a full-fledged cutting cycle.

As confidence in the Fed’s actions grew, credit spreads<sup>3</sup> narrowed and the U.S. dollar weakened somewhat, loosening financial conditions. Also, the Merrill Lynch Option Volatility Estimate (MOVE) Index, a key indicator of implied volatility in Treasury yields, fell in October after staying elevated following the Fed’s first two cuts. All of these signals, including rallies in cyclical parts of the equities and commodities markets, show that the

market now believes the Fed’s midcycle adjustment narrative.

### **Soft Economic Data Turn More Positive**

Some “soft” economic indicators, which are typically survey-based data measuring sentiment, have begun to turn upward. We monitor soft data, including various purchasing managers’ indices (PMIs), the Institute for Supply Management (ISM) new orders index, and regional Fed surveys of capital expenditure (capex) plans. To confirm that the Fed’s midcycle adjustment has been successful, we will need to see further improvement in soft data followed by better “hard” data, which measure actual production. However, because there is a lag between the implementation of monetary policy and when it affects the economy, sustained improvement in hard data is unlikely until the first quarter of 2020.

### **Positioned for Higher Rates and a Steeper Curve**

We expect Treasury yields to stay fairly steady or move slightly higher through the rest of 2019, potentially followed by a meaningful increase if hard data show improvement in early 2020. As a result, we have positioned the New Income Fund with shorter-than-benchmark overall duration.<sup>4</sup> Also, with the Fed keeping short-term rates steady while longer-term yields potentially increase on the back of stronger economic data, the fund is positioned for a steeper yield curve.

We added exposure to investment-grade corporate credit, focusing on our analysts’ picks of companies with cyclical businesses that would likely benefit the most from a healthier economy. Some of these corporates meaningfully lagged the year-to-date rally in the broad bond market amid recession concerns. We see potential in TIPS, which have

<sup>2</sup>Repurchase agreements are short-term loans collateralized by U.S. government securities.

<sup>3</sup>Credit spreads measure the additional yield that investors demand for holding a bond with credit risk over a similar-maturity, high-quality government security.

<sup>4</sup>Duration measures a bond’s sensitivity to changes in interest rates.

“We added exposure to investment-grade corporate credit...

underperformed most other fixed income segments to date in 2019, as a way to benefit from an upturn in inflation expectations.

#### **Consumer Confidence Remains Vital**

One of the most meaningful risks to our outlook for reflation is that consumer confidence could weaken, removing a major source of support for the

economy. As this year's manufacturing slump and uncertainty about the trade situation has dampened capex, buoyant consumer spending has helped keep the economy stable. Of course, another escalation in the trade dispute between the U.S. and China would present a meaningful headwind to the Fed's reflation efforts and could compel the Fed to cut rates again.

#### **WHAT WE'RE WATCHING NEXT**

At times in the past 10 years, the Chinese government has provided massive monetary and fiscal stimulus to boost the country's growth—and the global economy. While we do not anticipate that China will provide an overwhelming level of stimulus in the near future, we are monitoring Chinese economic data to analyze whether they are slowing enough to encourage the government to take measures to boost growth.

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