INSIGHT & PERSPECTIVE
Oh That Fed Reign

January 31, 2020

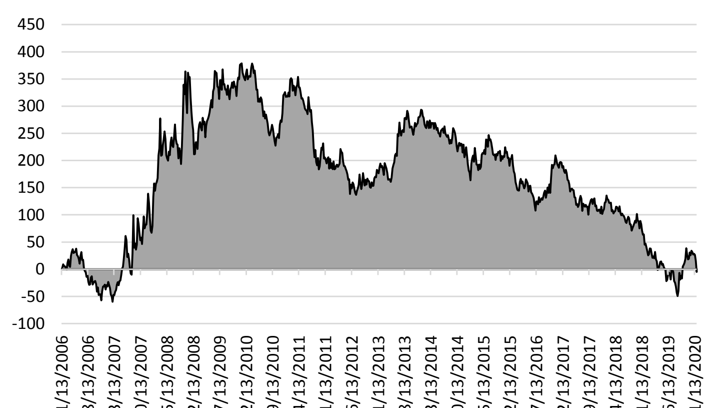
The recent drop in long-term interest rates may cause the Federal Reserve to lower the Fed funds rate again.

While we believe the Federal Reserve would like to leave its benchmark rate unchanged in this presidential election year, market conditions may make that untenable.

Typically, the Federal Reserve has employed an unwritten policy to remain above-the-fray in a U.S. presidential election year. That is, central bankers attempt to keep policy adjustments at a minimum to eliminate any pretense of election influence. The same would normally be expected this year; however, we believe market conditions may override policymaker hopes in this regard. Narrowing yield spreads (Figure 1), some prevailing economic weakness and the uncertain coronavirus impact may prompt the Federal Reserve to reach for the policy easing lever again (next meeting March 18).

The Federal Reserve has indeed managed its policy levers tactically to maintain the longevity of this business cycle. This was most evident when central bankers shifted abruptly from a tightening to easing interest rate bias in early 2019. Policymakers noticed some signs of apprehension among economic decision-makers and the central bank was faced with the prospect of narrowing Treasury yield spreads. The remedy was three straight interest rate cuts in July, September and October; serving as an "insurance policy" against slowing economic momentum and the risk of yield curve inversion.

Figure 1: 3-Month Treasury bill vs. 10-Year Treasury Bond Yield Spread
Source: Bloomberg Note: Spread in basis points

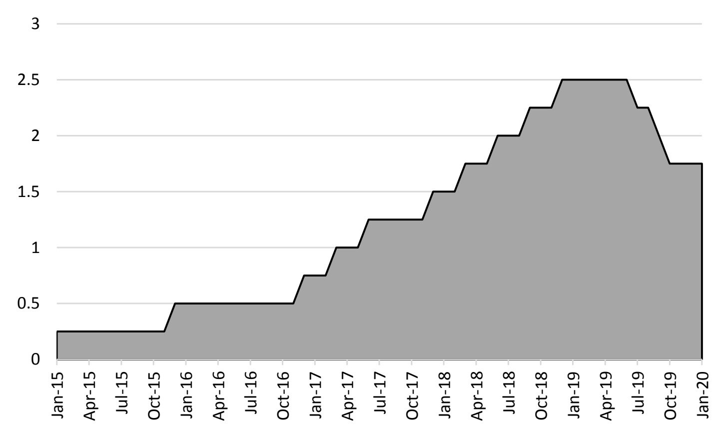


We believe the recent narrowing of Treasury yield spreads has again become a point of worry for the Federal Reserve. While the central bank took no action in their January 29 meeting, it is our view that further narrowing or inversion of the yield spread may call policymakers into action. Why? Because the inversion of short-term and long-term rates can upset the economy's funding mechanism and potentially weigh on business activity. Historically, the 3-month Tbill and 10-year Tbond yield spread has preceded nearly every recession in the post-war period.

The Federal Reserve stepped in to "fix" the 2019 yield inversion by reducing interest rates (Figure 2), and we anticipate the central bank would do that again if faced with the same situation. As mentioned, such activity is in-line with a seemingly more tactical Federal Reserve. Not only does the Fed understand the importance of a sustained yield inversion, but we believe central bankers are also concerned about the limited contents of the Fed's toolbox should the economy dip into recession. As a result, policymakers seem more inclined to be proactive against the risk of recession. This has been good for risky asset prices, including equities, although we worry that such a policy, at some point, may be challenged by the law of diminishing returns.

Figure 2: Federal Reserve's Policy Interest Rate - Fed Funds Rate (%)
Source: Bloomberg

The Federal Reserve moved quickly to change its policy bias and lowered rates when a 2019 yield curve inversion put the economy at risk.



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