Macro Strategy

LET'S TALK ABOUT RATE CUTS

Oliver Brennan

- **Tighter financial conditions and trade risks weighing on US growth**
- **We expect Fed pause to turn into Fed easing, first via QT**
- **Rate cuts are also on the table: we buy October fed funds**

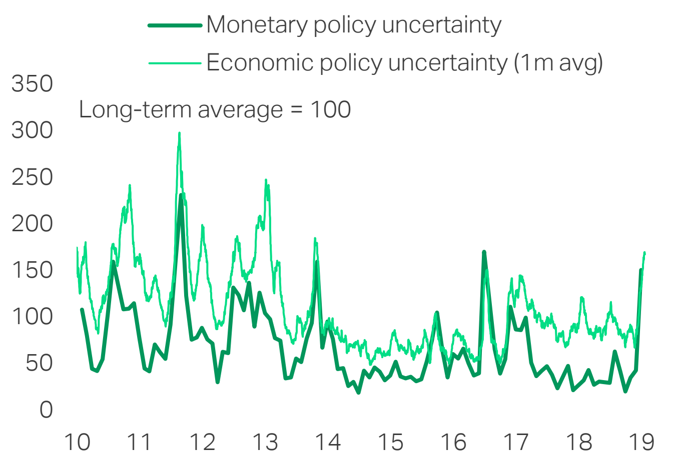
The longest shutdown in US government history has driven economic policy uncertainty to its highest level in more than five years. (Surprisingly, trade war risks have merely induced small periodic increases in US uncertainty which quickly faded away; it is in China – where policy uncertainty is currently at a record high – where the trade war is factored in.) At the same time, uncertainty about monetary policy has also risen sharply.

"Wait and see". FOMC policy tightening has been stable and predictable for the last two years, but now that the Fed has moved to a 'wait-and-see' mode, and has bought optionality around the pace of balance sheet reduction, uncertainty over the next step is high.

But shutdown has clouded the view. The FOMC is data-dependent just as the data itself has turned uncertain, not least because of the blackout at the Bureau of Economic Analysis. Of the data which is still being produced, US activity indicators suggest economic growth has peaked, and the OECD leading indicator is in "slowdown" territory (below 100 and falling). Tighter financial conditions suggests there is more decline in sentiment data to come.

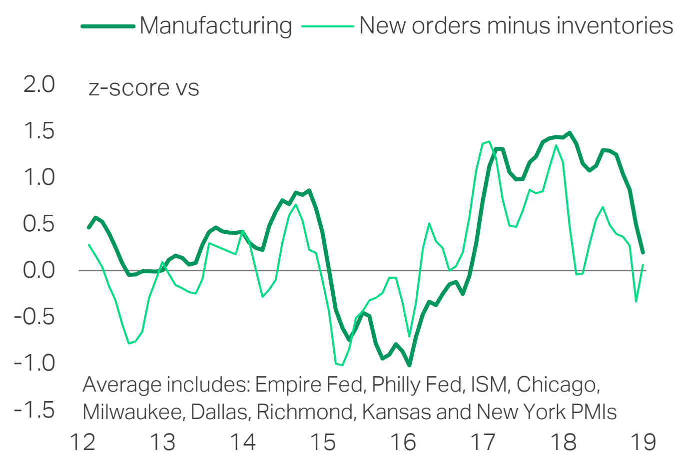
In part, this is due to global echoes of the trade war – trade into and out of China has slowed, leaving US companies with inventory overhangs which need to be worked through. Additionally, the market sell-off in Q4 has dented confidence, likely filtering through to data in Q2 this year.

US uncertainty at a three-year-high



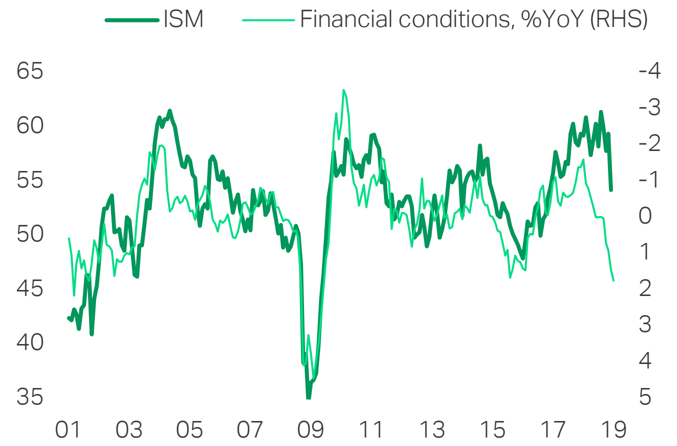
Source: Baker, Bloom & Davis

And activity is slowing



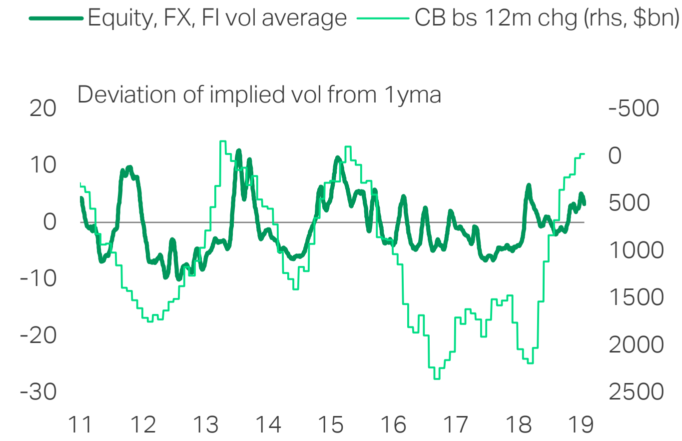
Source: Bloomberg, Regional sources

Tighter financial conditions mean ISM set to fall



Source: Datastream, TS Lombard

Slower pace of CB QE means vol has risen



Source: Bloomberg, national central banks, TS Lombard

The inversion of the front-end of the yield curve is also worrying our US economist Steve Blitz, who expects to see tightening credit conditions as a consequence: a feedback loop which could (as it has done in the past) lead to a recession.

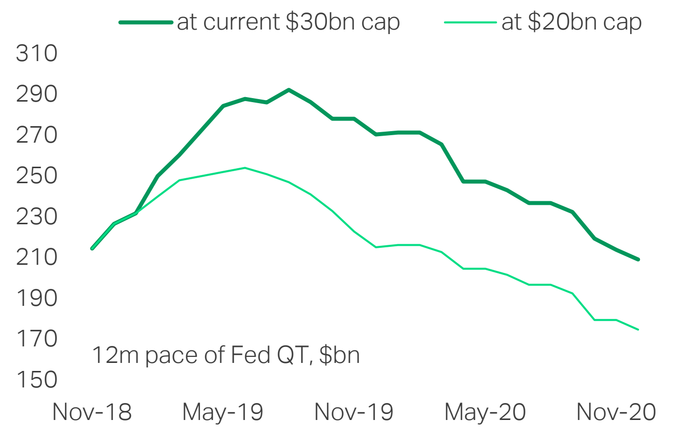
Two-step easing

QE suppressed vol and raised prices. The specific impact of QT on financial markets is still up for debate. Indeed, thanks to a doubling of the Federal budget deficit, the marginal impact of the Fed ceasing rollovers of $30bn of Treasuries per month is minimal. But on a global level, the impact of extraordinary monetary policy is harder to deny. Not only did asset purchases reduce term premia, they suppressed volatility as well.

QT (or maybe the end of ECB QE) reversed some of that. Previously in Macro Strategy we have shown how QE was the primary explanatory variable for fixed income returns for most of this decade. And although Fed QT may not be the specific culprit for the rise in volatility (the end of ECB QE better matches its recent rise), the lower global pace of QE is likely one cause for the increase.

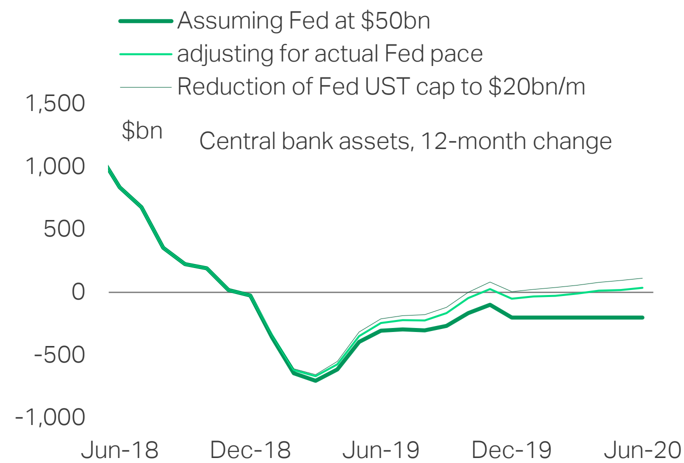
Easing QT should ease financial conditions. If the Fed were to change its own pace of QT, for example by reducing the cap on the pace of Treasury reductions, it would effectively become

Changing the pace of QT net injects liquidity



Source: NY Fed, TS Lombard

But only has a minimal impact globally



Source: National central banks, TS Lombard the marginal global provider of QE. Reducing the cap by $10bn (from $30bn to $20bn) would inject $50bn of extra central bank liquidity in total this year – a big change for the Fed's program but a tiny change globally compared to current projections. Even so, the move is an important signal, no matter the final impact.

After step one, step two. And this brings us to the second step: the QT step signals the Fed are on an easing bias, and the market joins the dots to expect a rate cut. Changing the pace of QT will not by itself have a material impact on growth. Through the confidence channel it will support investment, and asset prices, but it will not change the direction of trade war risks, new orders/inventories or fully offset the damage from the market sell-off in Q4.

Furthermore, it could risk inverting the yield curve – QE bull-flattened curves by suppressing volatility and cutting term premia, QT has unwound some of this; if the market interprets the move as "more QE" then term premia could fall further and with only 20bp between 2y yields and 10y yields, curve inversion is a risk.

We reckon Powell's FOMC is more pragmatic than previous committees, and will be more willing to act against the risk of curve inversion. In our view, the US economy needs a rate cut given signs of a slowdown. And slowing the pace of QT makes it more likely.

Market expectations of Fed policy have stabilised after the wobble around the new year, when at one point the market was discounting over 10bp of rate cuts for 2019. And although the slightly upward-sloping curve includes a non-zero probability of rate cuts, according to Bloomberg, market expectations of a cut this year are less than 5%. The market discounts a 20% chance of a rate *hike* by June. We reckon the balance of risks is the other way around: either the Fed cuts rates this year or does nothing.

We expect that once the pace of QT is slowed, the market will move to discount a greater chance of rate cuts in future meetings. If the pace is slowed at the March meeting, this puts a timescale on discounting cuts starting in Q2. We expect the rate cut to come after it becomes evident that data has not improved – thanks to the government shutdown, this means the cut will most likely take place in Q3.

We **buy the October fed funds future at 97.53 with a stop below 97.40:** the current price reflects a market expectation that the fed funds rate will be 2.47% on average in October (it is currently 2.4%). We reckon October is the optimal entry point given our expected timing of the rate cut and the shape of the fed funds curve: the December price is a little higher than the October price. We reckon there is a better chance of it averaging 2.15%, equivalent to a futures level of 97.85.

Model portfolio adjustments

The objective of Fed policy is ultimately to re-steepen the yield curve. Although slowing the pace of QT does risk further flattening, we reckon the continued high pace of Treasury issuance (it was over $1tn last year) and the lack of demand from EM reserve managers and from EA or Japanese investors will keep upward pressure on long-term yields. And if the curve were to flatten after QT, we expect the Fed would encourage market pricing of rate cuts. So we retain our curve steepener for now.

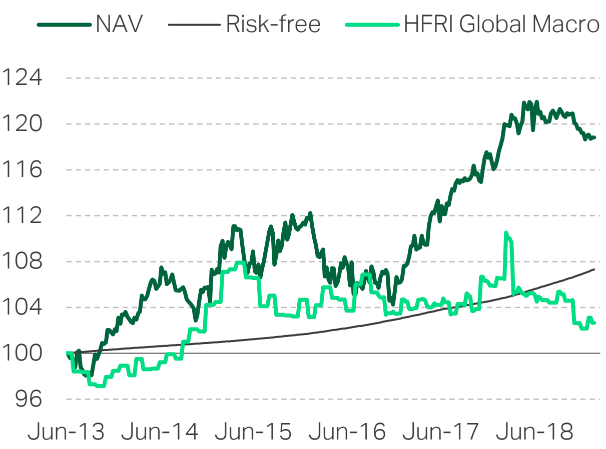
After the weak Korean export data reported on Monday – semiconductor exports fell by 8% y/y – KRW weakened by 1%. It has taken back some of that weakness now, but we take the opportunity to raise the stop on our USD/KRW position from 1095 to 1110.

Current trade recommendations

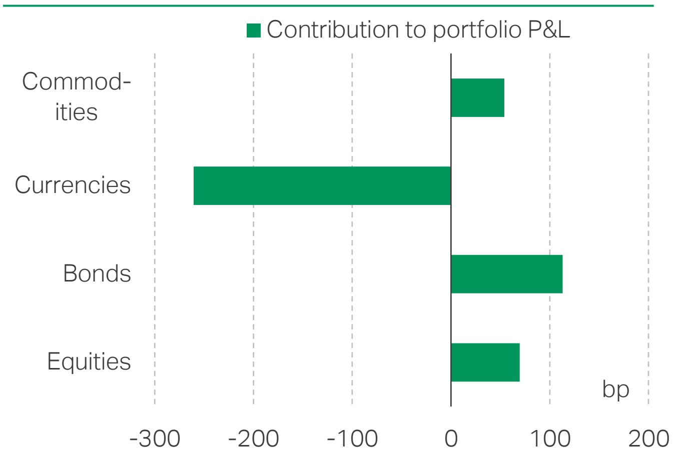
Theme	Trade	Date opened	Entry level	Last	P&L	Target	Stop	Original rationale / comment
Operation Untwist								
	Long US 2s10s steepener	07-Nov-18	25bp	16.4bp	-8.6bp			Budget and term premium to raise long end rates vs hiking cycle pause
Bolsonaro bounce								
	Long BRL/CNY	09-Jan-19	1.85	1.79	-3.5%	1.90	1.745	Economic optimism and reform to boost Brazilian assets
Trade boom bust								
	Long USD/KRW	16-Jan-19	1120.20			1140	1110	Semiconductor trade has fallen, tends to lead KRW
	Long AUD/CAD 2m put spread	16-Jan-19	0.23%	0.23%	0.00%			Chinese rough patch and risk to AU LNG export volumes/price
Next Fed rate move is a cut								
	Long October fed funds future	**23-Jan-19**	**97.53**			**97.80**	**97.40**	**Curve near-inversion, trade war and slowing growth warrants easing**

Bold indicates new trades or changes made this week.

Model portfolio historical performance



Performance contribution – last 12 months



Model portfolio metrics since inception

	Portfolio	HFRI Global Macro
Since Inception return	18.82%	2.66%
Annualized Return	**3.11%**	**0.47%**
2016	-4.89%	0.14%
2017	9.67%	2.47%
2018	2.58%	-3.02%
YTD	-0.22%	0.50%
MTD	-0.22%	
Volatility (ann.)	4.48%	4.00%
Sharpe ratio	**0.40**	**-0.18**
Sortino ratio	**1.26**	**0.19**
Alpha (12m, vs HFRI)	3.17%	
Beta (12m, vs HFRI)	0.18	
Corr (12m, vs HFRI)	0.29	
Corr (12m,vs MSCI World)	0.28	
Corr (12m, vs JPM GBI)	-0.21	
Max draw down (12m)	-3.05%	-6.67%

Best and worst trades – last 12 months

Best and worst performing trades of last 12 months	
Best	**Contrib. (bp)**
Long OIH US equity (14-Feb-18)	82
Long 1y10y USD 2.9% payer (28-Nov-17)	81
US 2s10s steepener (07-Nov-18)	77
Long WTI (14-Feb-18)	66
Long WTI / short Brent (06-Oct-17)	58
Worst	**Contrib. (bp)**
Long EUR / short GBP, CHF, AUD, USD (04-Oct-17)	-82
Short Brent /WTI spread (19-Sep-18)	-70
EUR/USD Call Spread (16-May-18)	-45
Long EUR / short AUD (03-Oct-18)	-38
Long EM ETF (03-Dec-18)	-36

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