ARX Market Commentary *"Turn Around"*

June 30, 2019

The Federal Reserve will cut interest rates tomorrow for the first time since the depths of the Financial Crisis in 2008. Investors are pricing in a quarter point reduction in the Federal Funds rate, to the 2-2 ¼% range, and a total of between 2 and 3 rates cuts before year-end.

The initiation of a new easing cycle represents a sharp reversal from the Fed's policy of slowly raising rates between 2015 and 2018, during which Fed Chair Jay Powell indicated a continuation of rate *increases* as recently as December. Those comments were met with a sharp equity market selloff and a series of Twitter rebukes from President Trump, who contends that the Fed has made a huge mistake by not already sharply cutting rates.

What is interesting is that this new easing cycle is beginning at a time when unemployment is below 4%, equity markets are near all-time highs, and economic data is still strong but moderating. Additionally, the Fed Funds rate of 2 ¼ - 2 ½% is at its lowest level ever to begin an easing cycle. So, what gives? Why is the Fed willing to use its scarce dry powder and cut rates when the US economy is this strong? We believe 3 primary factors are driving the decision:

1. Stronger linkages to other weakening global economies: The Fed believes that major central bank policies, yield curves, and currencies need to be more coordinated to reflect the globalization of economies. Europe's economy in particular is significantly weakening, and $13 trillion in international bonds are now trading with negative yields. This means that investors now have to *pay for the privilege* of lending money to Germany and other countries.
2. Trade and the economy: After a 10-year expansion, the US economy is in fact slowing down, and the Fed is trying to preemptively address this and also push inflation up toward its 2% long-term target. Additionally, the economic impact of President Trump's aggressive trade and immigration initiatives are hard to gauge at this point, so the Fed will err on the side of caution.
3. Political pressure: Perhaps most importantly, the Fed appears to be bowing to pressure from President Trump to cut rates heading into the 2020 election. Gone are the days of Fed independence, which curtails its credibility and ability to effect monetary policy.

We expect the Fed to give the market what it wants by cutting rates a quarter point and indicating further easing within a "data dependent" context. However, the Fed's abrupt pivot in policy stance doesn't come without risks. Much of the Fed's credibility, which drives its ability to be effective, is eroding as it is perceived to me more politically influenced and less independent. Also, starting an easing cycle from such low rate levels means the Fed won't have much dry powder to respond to a deep recession or credit crisis in the future. Low interest rates stimulate borrowing, but hurt retirees, insurance companies, and the very banks the Fed uses as its transfer mechanism for monetary policy. It's a slippery slope.

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