The Fed's Many Options for Tomorrow

June 18, 2019

by Team

of Knowledge Leaders Capital

Tomorrow will obviously be one of the most important news days of the year for financial markets with the Fed expected at the very least to signal that a rate cutting cycle is in the offing. Indeed, since the Fed last raised rates the yield curve has inverted at the important 10Y-3M spread, inflation expectations as priced by the bond market have plummeted from 2.2% to just 1.6%, and the bond market is already pricing in about 75bps of cuts by the end of the year. We also have several important voting Fed members on record signaling that a lower Fed Funds rate will be appropriate at some point in 2019.

Since all signs point to a rate cutting cycle, the questions are simply around when it will start, by how much will they initially cut (25bps or 50bps), and will the balance sheet policy change. Currently, the market only expects a 20% chance of a 25bps cut in the Fed Funds rate tomorrow and the market expects no change to the current balance sheet runoff policy.

Clearly, as is nearly always the case when it comes to Fed meetings, there is an opportunity for the Fed to surprise either hawkishly or dovishly tomorrow. By our math there are four probable outcomes of the meeting tomorrow. The interesting thing about each likely scenario is that long bond yields are likely to be either unchanged or lower in reaction to every outcome but one, the most dovish one. This stems from the fact that the bond market has already expecting significant rate cuts and therefore signaling a hawkish (or not dovish enough) tone could well cause the bond market to discount an even lower Fed Funds rate on the back of a deeper slowdown. In other words, if the Fed doesn't come out swinging tomorrow in order to try to arrest this slowdown, we are likely to get lower bond yields in the intermediate term. Below we list those outcomes in order of most hawkish to most dovish and provide the likely market impact from the decision:

1. Fed does not cut rates and signals that a rate cut may be appropriate later in the year (read the September meeting). Balance sheet policy remains unchanged.
    - This is a the most hawkish of the likely outcomes. The financial markets would likely read this is policy being too hawkish, causing long bond yields and equities to fall as a further slowing of economic growth is discounted.
2. Fed does not cut rates, but instead signals a rate cut of 25bps is likely in the near term (read the July meeting). Balance sheet policy remains unchanged.
    - This too is a somewhat hawkish outcome since the first rate cut is typically the largest rate cut. The long end of the bond market is likely to rally (lower yields) as the market views the move as less than what is needed to arrest the slowdown. Impact on equities would be small.
3. Fed does not cut rates, but instead signals a rate cut of 50bps is likely in the near term (read the July meeting). Balance sheet policy remains unchanged.
    - Now we are getting somewhere, and even though this is a somewhat dovish scenario long bond yields are likely to fall in sympathy with short rates, though perhaps not as much as short rates. Equities would likely rally.
4. Fed does not cut rates, but instead signals a rate cut of 50bps is likely in the near term (read the July meeting). Balance sheet runoff stops tomorrow and the Fed opens up the possibility of more QE down the road.
    - This is the least likely outcome and also the most dovish. Short rates may fall while the long end would likely selloff, steepening the yield curve and ushering in a risk on environment. In this dovish case, equities are likely to do quite well as a reflation trade takes hold, a la QE2.

Get the popcorn and take your seats. This one could be interesting.