The Fed's Great Balancing Act: A Policy Pivot

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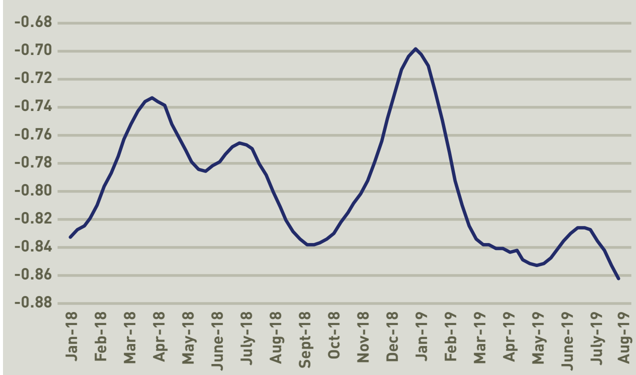
Late in second quarter 2019, the Federal Open Market Committee (FOMC) began signaling a strong bias towards lowering the fed funds rate target in an effort to sustain economic expansion amid growing macroeconomic concerns. Throughout much of 2019, Federal Reserve (Fed) Chairman Powell and many Fed governors reinforced a dovish message that emphasized patience and completely reversed the tightening bias that had been in place over the last couple of years.

Many market participants anticipated the Fed would embark on a series of rate-cutting measures beginning at its highly anticipated FOMC meeting on July 31. However, robust consumer spending data and the concomitant rebound in both June payrolls and second quarter GDP alleviated pressure on the Fed to move aggressively. Acknowledging "the implications of global developments for the economic outlook as well as muted inflation pressures," the Fed lowered the target fed funds rate by 25 basis points (bps) and announced its balance sheet normalization program would conclude on August 1, two months early. Notable were two dissenters who preferred no action at the meeting. The tone was consistent with the median of the "dot-plots," which showed less than half of FOMC participants expected two cuts by the end of 2019.

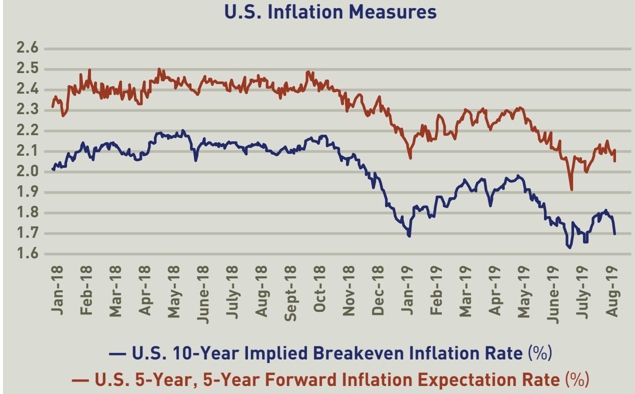
Considerable market volatility ensued during the press conference, where Chairman Powell characterized the reduction as a "mid-cycle adjustment," as opposed to the beginning of a prolonged easing cycle. Risk asset valuations weakened, gold prices fell, and the U.S. dollar strengthened. Two-year Treasury notes ended that day's trading session just 3 bps higher, but traded in a 15 bps range over the last three hours of the session! Overall, the U.S. Treasury curve flattened, and the 3-month/10-year curve moved further into negative territory. While well off the lows of early June, this curve has been inverted for more than two months.



Source: Bloomberg

Weaker capital spending data likely reflects the impact of trade uncertainty across the manufacturing sector. However, the U.S. economy continues to advance at an uninspiring, but satisfactory growth rate of about 2%. Certainly, markets did not anticipate a "hawkish" ease, and futures adjusted lower to price in more modest expectations for additional cuts. We would note the Fed's shift in forward guidance has helped lift inflation expectations, as well as further loosen financial conditions.

Over the last six months, we have been aware that the effects of escalating trade rhetoric on sentiment and increased uncertainty regarding geopolitical conditions could lead the Fed to respond with additional policy accommodation. With both reported and forward inflation measures remaining relatively benign, we believe the Fed can adjust its policy in an effort to sustain prolonged economic expansion for now. Due to the global low-rate environment and the significantly reduced perception of the neutral rate, we believe the Fed will likely balance the expected impact of its actions on growth and economic conditions against a desire to maintain flexibility.



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Given risks to the global economy and myriad geopolitical tensions, we are predisposed to maintain more defensive portfolio positioning. We believe a more placid environment, in which yields stabilize and fundamentals improve, could support a further advance in risk assets. We maintain a modest overweight to corporate credit, and this continues to provide incremental outperformance across our strategies. The lack of compensation investors currently receive for taking incremental credit risk should reward a portfolio construction process focused on risk-optimization across sector, quality, and key rate durations. We are evaluating opportunities to enhance portfolio yield and move up in quality across our strategies.

Indexes

The Chicago Fed's **National Financial Conditions Index (NFCI)** provides a comprehensive weekly update on U.S. financial conditions in money markets, debt and equity markets, and the traditional and "shadow" banking systems. Positive values of the NFCI indicate financial conditions that are tighter than average, while negative values indicate financial conditions that are looser than average.
