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FED SETTING UP FOR A RATE CUT

SUMMARY

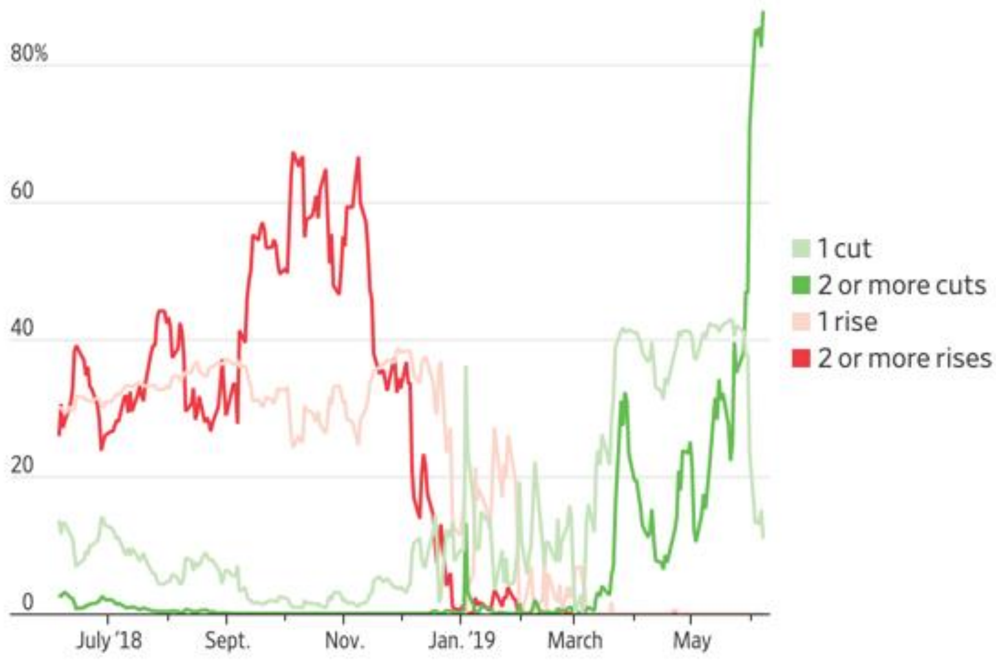
- **The Federal Reserve is expected to signal a willingness to cut interest rates.**
- **Although recent US economic data has been mostly positive, the Fed might be concerned about the direction of the global economy, and recent manufacturing survey data that shows a more problematic outlook.**
- **When the Fed cuts interest rates after a long cycle of raising them, historically, that has led to strong stock market returns with two major exceptions.**

MARKET PARTICIPANTS ARE EXPECTING A RATE CUT

The Federal Reserve board will meet on June 18 and 19 to discuss the economic outlook and expectations for monetary policy. We do not expect the Fed to take any immediate action following the meeting, but we do anticipate that they will signal their willingness to cut rates in the future. From Fed watcher Tim Duy:

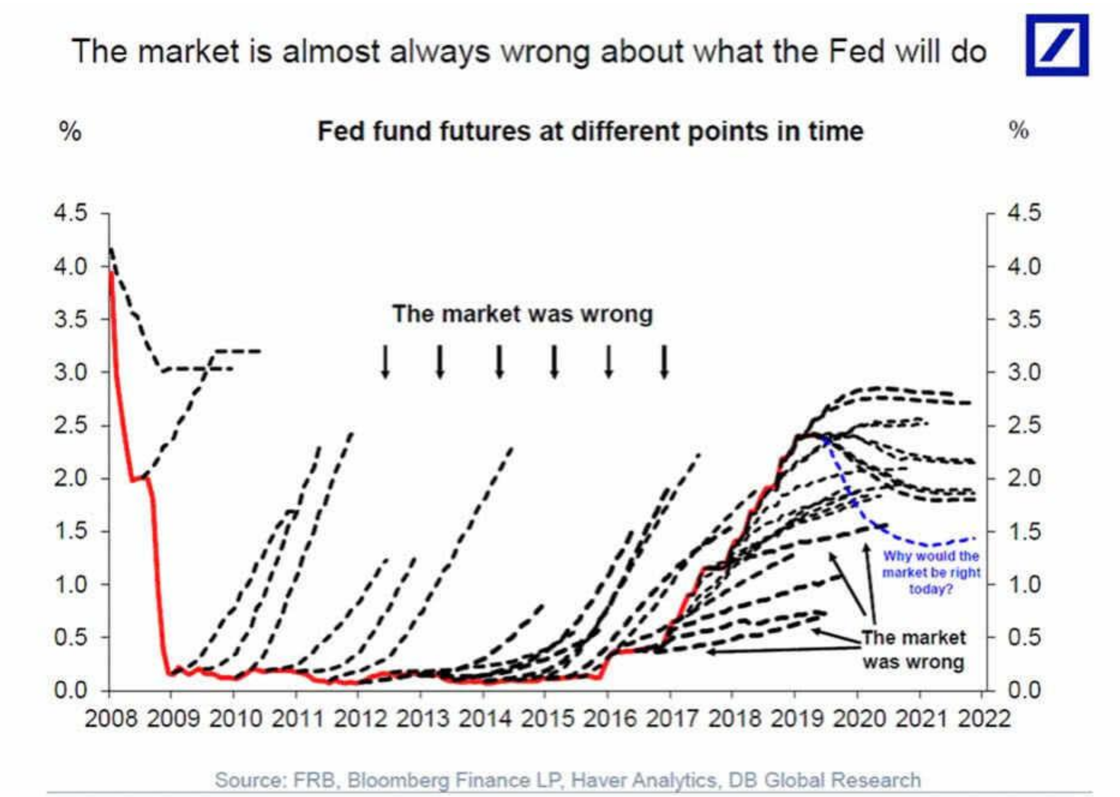
In the FOMC statement, I expect the Fed will signal a more dovish stance by replacing "the Committee will be patient" with "the Committee will act as appropriate" to sustain the expansion. I would expect Powell in his press conference to note that "appropriate" policy could be a rate hike, but we all kind of know which way the wind is blowing. It would be a signal that the odds of a rate cut clearly outweigh the odds of a rate hike.

The market thinks rate cuts are a foregone conclusion. In the Fed Funds Futures market, which is a way for traders to bet on where they think future short-term interest rates might be, investors are pricing in at *least* two rate cuts by the end of the year:



Source: CME Fedwatch Tool

But just because the market is expecting a rate cut, doesn't mean the Fed will oblige. In fact, the market has been terrible at predicting what the Fed will do next (chart from Deutsche Bank):

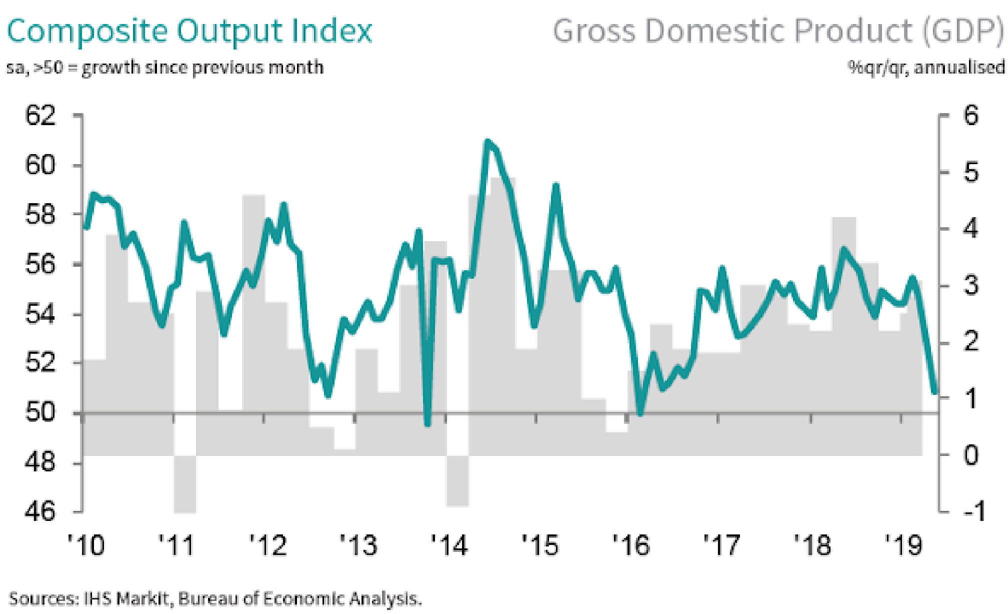


The Fed can, however, signal their willingness to cut while continuing to monitor the data for any weakness that would justify lowering interest rates. Even if the data does not indicate a weakened economy by the time the Federal Reserve Board meets again in July, the Fed could cut rates anyway, acknowledging that their December 2018 rate increase was a policy error.

WHY IS THE FED CUTTING RATES IF ECONOMIC DATA IS MOSTLY GOOD?

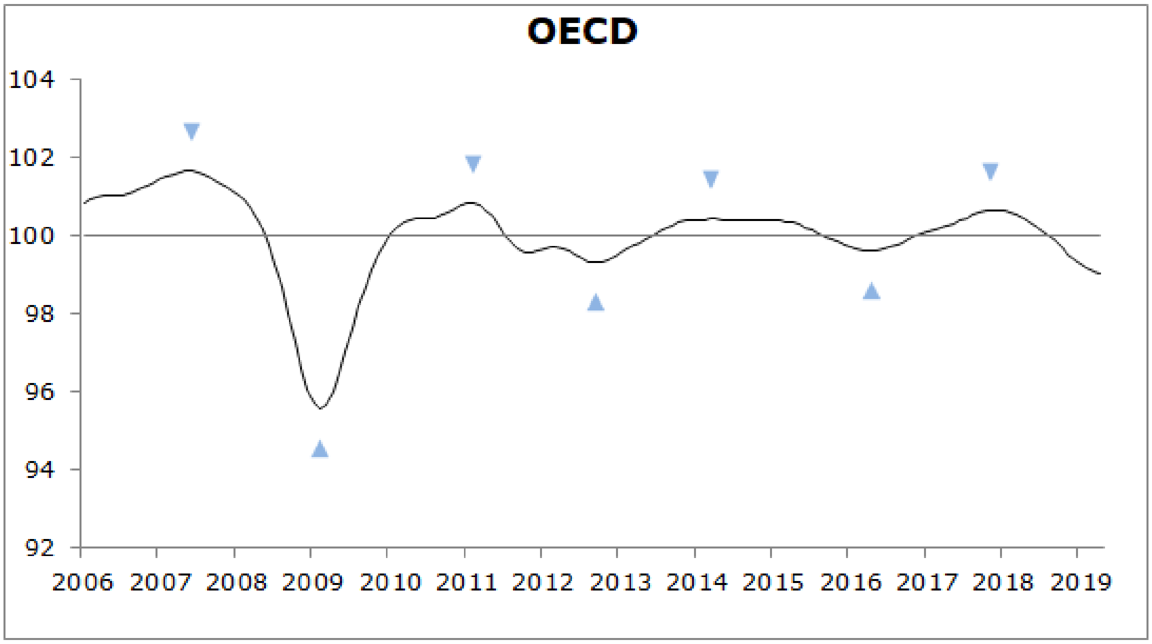
While there are pockets of weakness in the US economy (most pronounced in the housing market), overall data has been positive. Retail sales rebounded after a lousy winter. Employment growth was weaker than expected last month, but *leading* indicators of employment, like initial claims, look fine. Even industrial production rebounded last month.

If the hard-economic data looks good, why would the Fed lower interest rates? Because "soft" economic data, driven by surveys, continues to weaken. The monthly Purchasing Managers' Index (PMI) surveys different companies and asks them whether things are getting better or worse in different areas of their businesses. Results of both the manufacturing and services surveys have been declining. A blend of both shows a big drop, but it still remains at a level above 50—the threshold that separates economic expansion from contraction (from IHS Markit):



The blended PMI suggests US GDP growth will slow to between 1-2%.

In addition, while the US is still expanding (albeit slowly) global economic growth remains in decline (from the Organization for Economic Co-operation and Development):



Finally, with uncertainty about the length and potential impact of continued tariffs with China, the Fed doesn't have the luxury of waiting around to see if the hard data deteriorates further. By then, it might be too late.

IF WE GET A RATE CUT, HOW MIGHT THE MARKETS REACT?

Historically, when the Fed cut rates, it resulted in mostly positive returns. The S&P 500 has performed well, with two major exceptions (table from LPL):

Date of First Rate Cut	Hikes Prior to the Rate Cut	S&P 500 Index Returns 6 Months Later	S&P 500 Index Returns 12 Months Later
9/18/07	17	-14.6%	-23.9%
1/3/01	6	-9.5%	-14.3%
9/29/98	1	22.6%	20.9%
7/6/95	7	11.5%	21.4%
6/5/89	6	8.9%	14.1%
10/22/87	5	4.8%	13.9%
9/27/84	5	7.5%	8.6%
	Average Return	4.5%	5.8%
	Median Return	7.5%	13.9%

Source: LPL Research, Bloomberg 06/13/19
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The last two cycles the Fed was behind the curve; in both cases, a recession started within one quarter. In prior periods, results were positive. The market was higher 6 and 12 months later each time with a median return 13.9% a year later.

The above table explains why the Fed needs to get ahead of any further downturn. If they wait too long to cut, the economy may have too much downward momentum and a recession is likely.

We do not believe the economic cycle will top in the next quarter or two, so the Fed still has time. If that is the case, we expect future market returns to look more like the rate cut cycles from 1984 to 1998 rather than the last two recessions.

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