Trending…

June 2019

PGIM FIXED INCOME

The Fed Clears the Way for Cuts as the Market Seeks Even More

By Ellen Gaske, PhD, CFA, Principal and Lead Economist, G10 Economies, Global Macroeconomic Research Team and Robert Tipp, CFA, Managing Director, Chief Investment Strategist and Head of Global Bonds

Although the Fed remained on hold at its June 2019 meeting, its statement was about as dovish as could be expected given that FOMC participants appear fairly evenly divided on the need for rate cuts going forward. The split in policy views is likely a reflection of cross currents in the economic backdrop that the Fed cited: an upbeat assessment of the labor market (strong), economic activity (rising at a moderate rate), and consumer spending (picking up). But weakness in business fixed investment, sub-2% inflation, weaker growth abroad, and trade war uncertainties were enough for many FOMC participants to pencil in rate cuts for this year and to tip their median projection to an expectation for a full rate cut by next year**. Arguably, the most dovish outcome of the Fed's meeting was a drop in Fed officials' median estimate of the long-run neutral Fed Funds rate to 2.5% from 2.8% as of last March.**

The Fed has thus created more optionality for itself, clearing the way for possible rate cuts in the second half of this year. What we know at this point is that domestic demand has been picking up from a soft patch earlier this year, led by a rebound in consumer spending from a muted 1.3% pace in Q1 2019 to a 3%+ pace at this point. Housing starts, on a general decline since the spring of 2018, appear to be improving. The unemployment rate remains low, initial unemployment claims are near all-time lows, and while business investment remains muted, the S&P 500 Index is near all-time highs. Thus far, it appears that the U.S. economy has been fairly resilient to escalating trade tensions with China.

However, this spring's rebound in activity has been on the back of a 60 bp decline in 10-year Treasury rates this year and an almost 100 bp decline in mortgage rates since last fall. **Therefore, we expect the Fed will need to ratify at least a portion of the rate cuts that the market has been pricing in for the pickup in domestic demand to be sustained. Our base case now expects two rate cuts in the second half of 2019—more than what the median Fed projection has penciled in, but less than the three cuts the market has been pricing in.**

Factors Affecting Market Expectations

Given the backdrop of a Fed moving towards rate cuts, we believe the market will err on the side of pricing in lower rates, perhaps even pricing in more than the Fed delivers. **While that may not seem intuitive, two factors are likely to contribute to this phenomenon. First, the global backdrop is one where rates of other major economies are substantially lower than U.S. rates. As a result, investors are likely to see U.S. rates, which have a theoretical prospect of at least falling towards zero, as attractive relative to their own local markets.** Notably, this is despite the fact that U.S. yields may actually be lower on a currency-hedged basis.

Second, investors may be concerned that the Fed will be forced to lower rates more quickly over the cycle to potentially counteract potential geopolitical risks (including trade frictions) and/or a spontaneous continued moderation or more substantial slowdown in growth and/or inflation. The weighted average of these scenarios reflected by the market may be lower than the *modal, or most likely*, path.

This environment of moderate growth and inflation, supported by a Fed intent on extending the economic expansion, should prove positive for the bond market. It will likely keep yields low and range bound and encourage investors to take risk by buying higher-yielding, non-government spread product, such as emerging market and structured product assets, as well as both investment grade and below investment grade corporate bonds.

For Professional Investors Only. All Investments involve risk, including the possible loss of capital.

Source(s) of data (unless otherwise noted): PGIM Fixed Income as of June 2019

PGIM Fixed Income operates primarily through PGIM, Inc., a registered investment adviser under the U.S. Investment Advisers Act of 1940, as amended, and a Prudential Financial, Inc. ("PFI") company. PGIM Fixed Income is headquartered in Newark, New Jersey and also includes the following businesses globally: (i) the public fixed income unit within PGIM Limited, located in London; (ii) PGIM Japan Co., Ltd. ("PGIM Japan"), located in Tokyo; and (iii) the public fixed income unit within PGIM (Singapore) Pte. Ltd., located in Singapore. Prudential Financial, Inc. of the United States is not affiliated with Prudential plc, which is headquartered in the United Kingdom. Prudential, PGIM, their respective logos, and the Rock symbol are service marks of PFI and its related entities, registered in many jurisdictions worldwide.

These materials are for informational or educational purposes only. The information is not intended as investment advice and is not a recommendation about managing or investing assets. In providing these materials, PGIM is not acting as your fiduciary. These materials represent the views, opinions and recommendations of the author(s) regarding the economic conditions, asset classes, securities, issuers or financial instruments referenced herein. Distribution of this information to any person other than the person to whom it was originally delivered and to such person's advisers is unauthorized, and any reproduction of these materials, in whole or in part, or the divulgence of any of the contents hereof, without prior consent of PGIM Fixed Income is prohibited. Certain information contained herein has been obtained from sources that PGIM Fixed Income believes to be reliable as of the date presented; however, PGIM Fixed Income cannot guarantee the accuracy of such information, assure its completeness, or warrant such information will not be changed. The information contained herein is current as of the date of issuance (or such earlier date as referenced herein) and is subject to change without notice. PGIM Fixed Income has no obligation to update any or all of such information; nor do we make any express or implied warranties or representations as to the completeness or accuracy or accept responsibility for errors. **All investments involve risk, including the possible loss of capital. These materials are not intended as an offer or solicitation with respect to the purchase or sale of any security or other financial instrument or any investment management services and should not be used as the basis for any investment decision. No risk management technique can guarantee the mitigation or elimination of risk in any market environment. Past performance is not a guarantee or a reliable indicator of future results and an investment could lose value. No liability whatsoever is accepted for any loss (whether direct, indirect, or consequential) that may arise from any use of the information contained in or derived from this report. PGIM Fixed Income and its affiliates may make investment decisions that are inconsistent with the recommendations or views expressed herein, including for proprietary accounts of PGIM Fixed Income or its affiliates.**

The opinions and recommendations herein do not take into account individual client circumstances, objectives, or needs and are not intended as recommendations of particular securities, financial instruments or strategies to particular clients or prospects. No determination has been made regarding the suitability of any securities, financial instruments or strategies for particular clients or prospects. For any securities or financial instruments mentioned herein, the recipient(s) of this report must make its own independent decisions.

Conflicts of Interest: PGIM Fixed Income and its affiliates may have investment advisory or other business relationships with the issuers of securities referenced herein. PGIM Fixed Income and its affiliates, officers, directors and employees may from time to time have long or short positions in and buy or sell securities or financial instruments referenced herein. PGIM Fixed Income and its affiliates may develop and publish research that is independent of, and different than, the recommendations contained herein. PGIM Fixed Income's personnel other than the author(s), such as sales, marketing and trading personnel, may provide oral or written market commentary or ideas to PGIM Fixed Income's clients or prospects or proprietary investment ideas that differ from the views expressed herein. Additional information regarding actual and potential conflicts of interest is available in Part 2A of PGIM Fixed Income's Form ADV.

In the United Kingdom and various European Economic Area ("EEA") jurisdictions, information is issued by PGIM Limited with registered office: Grand Buildings, 1-3 Strand, Trafalgar Square, London, WC2N 5HR. PGIM Limited is authorised and regulated by the Financial Conduct Authority of the United Kingdom (Firm Reference Number 193418) and duly passported in various jurisdictions in the EEA. These materials are issued by PGIM Limited to persons who are professional clients as defined in Directive 2014/65/EU (MiFID II). In certain countries in Asia, information is presented by PGIM (Singapore) Pte. Ltd., a Singapore investment manager registered with and licensed by the Monetary Authority of Singapore. In Japan, information is presented by PGIM Japan Co., Ltd., registered investment adviser with the Japanese Financial Services Agency. In South Korea, information is presented by PGIM, Inc., which is licensed to provide discretionary investment management services directly to South Korean investors. In Hong Kong, information is presented by representatives of PGIM (Hong Kong) Limited, a regulated entity with the Securities and Futures Commission in Hong Kong to professional investors as defined in Part 1 of Schedule 1 of the Securities and Futures Ordinance. In Australia, this information is presented by PGIM (Australia) Pty Ltd ("PGIM Australia") for the general information of its "wholesale" customers (as defined in the Corporations Act 2001). PGIM Australia is a representative of PGIM Limited, which is exempt from the requirement to hold an Australian Financial Services License under the Australian Corporations Act 2001 in respect of financial services. PGIM Limited is exempt by virtue of its regulation by the Financial Conduct Authority (Reg: 193418) under the laws of the United Kingdom and the application of ASIC Class Order 03/1099. The laws of the United Kingdom differ from Australian laws. In South Africa, PGIM, Inc. is an authorised financial services provider – FSP number 49012.

© 2019 PFI and its related entities.

2019-2982