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The Fed cuts rates—now what?

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Title graphic: The first rate cut in over a decade

On July 31, the Federal Reserve cut the federal funds rate for the first time in over a decade. While the cut was well telegraphed and widely expected by the markets, questions remain as to exactly why the Fed decided to cut rates now. After all, less than a year ago, in October of 2018, Fed chair Powell told the markets that "we were a long way from a neutral interest rate," and just last December the Fed increased the federal funds rate.

Title graphic: Why cut rates now?

For a Fed that claims to be data dependent, very little has actually changed in the Fed's own forward-looking economic projections over the last ten months. In fact, the Fed has made no changes in its forward-looking GDP forecasts and we see only slight downgrades in their forward looking inflation forecasts. Geopolitically, there have been some changes, and the escalation in the trade dispute between the U.S. and China has had a negative impact on future growth prospects. For now, however, most of the damage remains in manufacturing segments of the economy as consumer confidence remains solid. As a result, global growth projections have come down a bit, but not to levels that should be overly concerning for the Fed.

So why cut rates now? The Fed is concerned that downside risks to the economy have increased, and it is reducing rates proactively in an effort to guard against downside surprises. Our concern is that this rationale deviates from the Fed's stated reliance on data dependence, and the Fed risks being pushed into future policy action by financial markets, rather than relying on economic performance.

Title graphic: Investor implications

The Fed certainly looks like it is going to reduce rates further this year, and this is in line with our updated year-end rate target expectations. The fed funds futures market, however, expects at least three more rates cuts this year—a stance we view as aggressive in light of current data. That said, negative surprises could lead the Fed to more aggressive action.

With this in mind, we recommend that investors position portfolios near a neutral maturity profile. Lower rates should be supportive of risk-based assets, if growth remains stable. Given market uncertainties, we recommend that investors look to move up in quality within their fixed income portfolios.

Risk Considerations

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. Investments in fixed-income securities are subject to interest rate, credit/default, liquidity, inflation and other risks. Bond prices fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can result in the decline in the bond's price. Credit risk is the risk that an issuer will default on payments of interest and principal. This risk is higher when investing in high yield bonds, also known as junk bonds, which have lower ratings and are subject to greater volatility. If sold prior to maturity, fixed income securities are subject to market risk. All fixed income investments may be worth less than their original cost upon redemption or maturity.

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