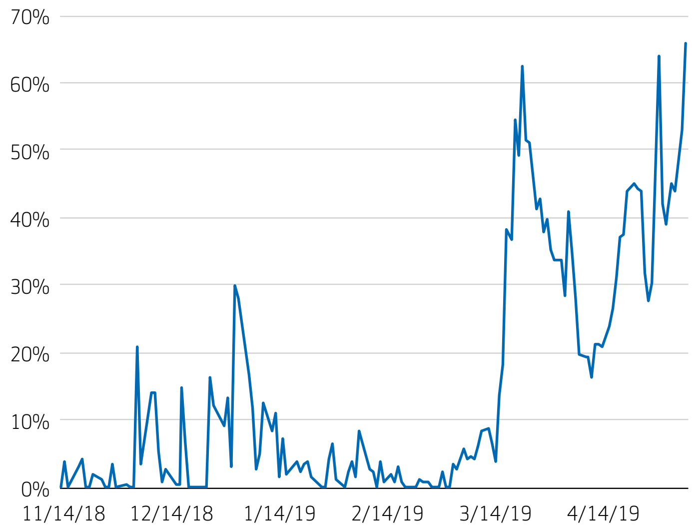
TRADE RHETORIC AFFECTING RATES

By Calvin Norris, CFA

The mounting trade rhetoric by Trump and China is spooking markets, with the S&P down 2.4%, and Treasury yields 5-8 basis points lower, led by the front-end. This is pushing market-implied odds of the FOMC cutting rates by year end to new highs—now 67% (see Exhibit 1). Historically, market-implied odds appear to have had a fair amount of influence over the FOMC's ultimate decision on rates adjustments.

Exhibit 1: Overnight indexed swap implied odds of FOMC rate cut by year end



Source: Bloomberg, Aegon AM US. As of May 13, 2019.

What is unusual about this time around is that the catalyst is the market's interpretation of an exogenous event on the economy. Since it is not directly related to the market's interpretation of ordinary oscillations in the economy, the FOMC has neither special insight nor credibility relative to the market; effectively neutering the FOMC's decision-making ability. The FOMC's hands are tied. It can either: a) announce right away that it will cut rates to support the economy if additional tariffs go into place, or b) delay saying it will cut rates. While we favor the latter, either way, the FOMC will likely have to accept a rate cut may be in the cards if this all plays out as the markets fear.

Of course, all of this can be reversed very quickly if China/Trump reach a deal in the near future. This is one of the reasons we believe the FOMC will wait before they say much of anything. The FOMC is likely hoping that cooler heads prevail, and this will all resolve itself before the Fed has to show its hand. However, this also implies that things may get worse before they get better.

For this reason (and the fact that we don't have a crystal ball on trade negotiations), we are a bit reluctant to fade the move today, with the caveat that Treasurys are starting to encounter significant resistance, capped by the March lows of 2.33% on the 10-year Treasury. A break in yield below this level would open the door to a move towards 2.15%, followed by 2.00%. We believe that such a market move would force the FOMC's hand, with some kind of statement it is prepared to cut if the economic situation warrants, possibly very soon.

At this point, while we're not suggesting chasing the Treasury market outright by going long/longer, we continue to prefer to express our view on the Fed via curve steepeners. Regardless of how this all shakes out, it's going to be a bumpy ride.

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