# WHY WOULD THE FED CUT?

Financial market expectations in 2019 have pivoted from a potential U.S. Federal Reserve rate hike to a rate cut. If rates are cut, what would be the cause – financial market pressures, an economic downturn, or maybe a change in policy?

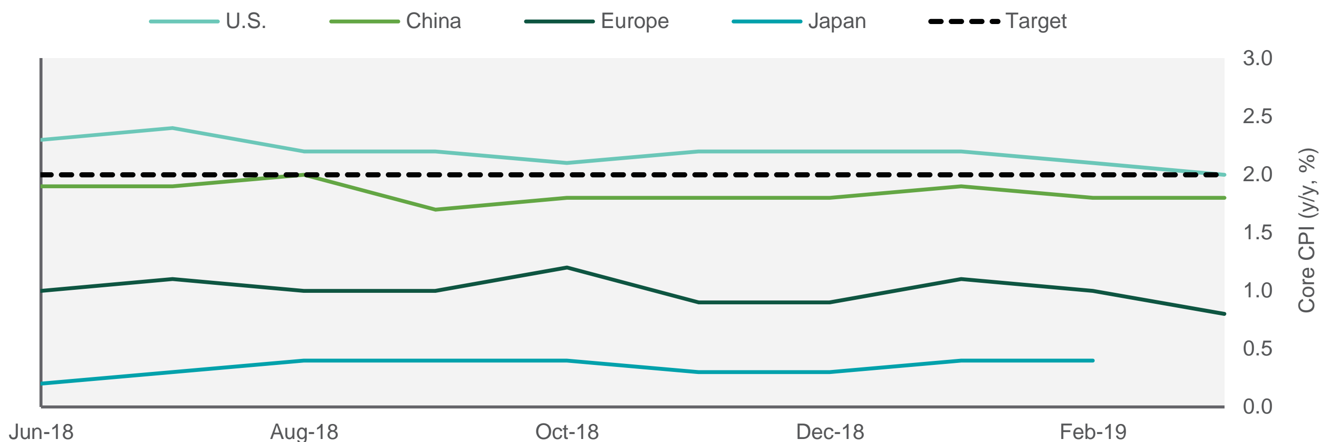
We think a changing policy framework would be the most likely catalyst. A great surprise to central bankers globally has been the benign behavior of inflation despite steadily falling unemployment rates and ultra-easy monetary policy. While disinflation (a falling rate of inflation) is beneficial to consumers, policy makers worry about the deleterious effects of deflation (falling prices), which can wreak havoc on economic activity and the ability to service debt. The risk of deflation should increase markedly during the next recession, warranting current attention. Core measures of inflation, which exclude volatile food and energy prices, have regularly undershot expectations, contributing to the inability to consistently hit the 2% target.

We think central bankers will be increasingly talking about a “symmetrical” inflation target. Achieving an overall inflation level of 2% would require allowing inflation to run above that level to offset the previous softer readings. All else being equal, this would lead to easier monetary policy. While we think global growth will positively surprise investors over the next year, expectations are low and the overall growth rate will remain moderate. This shouldn’t lead to demand pressure on global prices, as the sharing global economy continues to aid supply.

Amongst the major economies, the U.S. has the most momentum in current activity measures due to the relative self-reliance of its U.S. economy. The U.S. labor markets bounced back smartly in March, indicating the weak February jobs report was anomalous. Chinese growth is tentatively showing early signs of benefitting from the government’s stimulus plans, including tax cuts at both the individual and enterprise level. These actions are significant in size as they are estimated to total 2.5%-3.0% of Chinese GDP. European growth remains the laggard, as steady consumer spending/services growth continues to be held back by trade-restrained manufacturing activity. At present, a hard Brexit scenario has been avoided, as a six-month delay has been agreed (a delay has been our base case scenario). Broad resolution of the U.S./China trade dispute would be a clear positive for global growth, but a more narrow agreement seems the more probable outcome.

**REFUSING TO COOPERATE – INFLATION FALLING BELOW TARGET**

Only the US is at targeted inflation levels – and it’s heading in the wrong direction.




Source: Northern Trust Global Asset Allocation, Bloomberg. Inflation data from 6/30/2018 through 3/31/2019. Japan data is through 2/28/2019.

## Conclusion

In our investment strategy meetings this month, we tested our theses that growth would beat the restrained outlook of investors, and that monetary policy would remain accommodative over the next year. We upgraded our outlook for U.S. and emerging market growth in January – and the U.S. growth data has been reassuring. In addition to March's bounce-back in job creation, measures of industrial activity have also improved over the last month. Evidence of an upturn in emerging market economies has been developing, including a strong improvement in "economic surprise indexes" since mid-March. This is evidence that economic reports, relative to consensus expectations, are starting to improve. This month, we upgraded our expectations for growth in developed markets outside the U.S., primarily based on the very low expectations for Europe. The European service economy has been expanding relatively steadily, with real headwinds coming from the industrial sector. Continued improvements in the U.S. and emerging market growth outlook will contribute to an improving outlook for Europe, which is relatively dependent on export growth.

Our monetary policy deliberations were mostly focused on the Fed and the European Central Bank (ECB). We expect the Fed's policy model to evolve over time, potentially embracing an approach to inflation that will tolerate (or even seek) a temporary rise in prices to achieve average inflation levels near the policy target. There is concern in some corners of the market that ECB President Mario Draghi's retirement on October 31st could lead to a more hawkish direction from the ECB. We believe that there is a sufficient moderate core of the ECB that embraces the current programs that a U-turn in policy looks unlikely.

We made no changes in our tactical asset allocation recommendations this month, as our global policy model is performing well in the current market environment and we feel good about our positioning. In addition to our normal focus on economic developments, a number of key developments will be on our radar. The largest democratic election in the world takes place in India from mid-April through mid-May, and is to some extent a referendum on Prime Minister Narendra Modi. European Parliamentary elections in late May will again test the Populist wave, while the Fed's annual Jackson Hole conference in late August will give the Fed a chance to sound out new approaches to monetary policy. The Brexit deadline has been extended until October 31st, as forecast in our base case scenario. Additionally, while some agreement on the U.S./China trade dispute seems likely mid-year, trade frictions are likely to remain among many countries for the foreseeable future.

### INVESTMENT PROCESS

The asset allocation process develops both long-term (strategic) and shorter-term (tactical) recommendations. The strategic returns are developed using five-year risk, return and correlation projections to generate the highest expected return for a given level of risk. The objective of the tactical recommendations is to highlight investment opportunities during the next 12 months where the Investment Policy Committee sees either increased opportunity or risk.

The asset allocation recommendations are developed through the Tactical Asset Allocation, Capital Markets Assumptions and Investment Policy Committees.

Past performance is no guarantee of future results. Returns of the indexes also do not typically reflect the deduction of investment management fees, trading costs or other expenses. It is not possible to invest directly in an index. Indexes are the property of their respective owners, all rights reserved. This newsletter is provided for informational purposes only and does not constitute an offer or solicitation to purchase or sell any security or commodity. Any opinions expressed herein are subject to change at any time without notice. Information has been obtained from sources believed to be reliable, but its accuracy and interpretation are not guaranteed.

Northern Trust Asset Management comprises Northern Trust Investments, Inc., Northern Trust Global Investments Limited, Northern Trust Global Investments Japan, K.K., NT Global Advisors, Inc. and investment personnel of The Northern Trust Company of Hong Kong Limited and The Northern Trust Company.

ViewPoints reflects data as of 4/16/19.

*Powered by*

©2019. All Rights Reserved.