Private Bank

Fixed Income Strategy

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What's an ounce of easing worth?

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- **Markets have priced a much more aggressive (dovish) Fed with 75bps of cuts priced into markets by year-end.**
  - At their June 19 meeting, Fed Chair Powell gave markets no reason to believe a July rate cut would be off the table. References to "patience" were removed from the Fed's statement, while many overarching comments were added to support their interest in sustaining the current expansion. This was highlighted in our post-Fed strategy bulletin.
  - Today, markets are pricing in a 100% chance of a cut at their upcoming July 31 meeting. This leads to the debate of whether the Fed should cut by 25bp or 50bp. During his press conference, Powell stated "*an ounce of prevention is worth a pound of cure*" in response to a question over the potential size of any future easing. One thing is certain, with the S&P 500 reaching new highs and credit spreads tightening, financial markets clearly prefer an easier Fed.
  - At this stage, for the Fed not to cut rates in July, it would likely require progress between US/China on trade ***and*** improvement in the US macro outlook. In this scenario, the upward repricing in Fed expectations would result in higher yields and a flatter US Treasury yield curve.
  - If trade negotiations do not improve and the US macro outlook stagnates, the Fed will likely need to capitulate in July. Some of this has already been priced into markets, with 2-year Treasury yields falling 50bp over the last month and the UST curve (bull) steepening.
  - In our view, what happens beyond July will be contingent on trade and its impact on the US economy. As Citi Private Bank's global equity strategist Wietse Nijenhuis highlighted in his latest piece "Melt Up or Melt Down", we do not presume recession in the near-term is inevitable. Therefore we find the extent of the cuts being priced into Fed expectations to be stretched. For easing to meet current market pricing (100bp through 2020), recession would likely need to be imminent. In our view, this would not be a positive outcome for equity or high yield bond markets.
  - **Our base case**: Unless market pricing adjusts, we expect the Fed to cut rates by *at least* 25bp in July. Ten-year Treasury yields are likely to remain around 2.0%, with risks skewed to the downside. LIBOR rates are also likely to remain susceptible to the Fed outlook, though current levels already reflect a 25bp rate cut in the next 3 months. In other words, we would need to see a larger rate cut for LIBOR rates to fall meaningfully below current levels.
- **What has past Fed rate cuts meant for fixed income markets?** If history is a guide, fixed income markets tend to perform well during periods of Fed easing **(Figure 1)**. On average, in the 12 months following the first Fed rate cut, US aggregate bond indices generated returns in excess of 9%. Indeed, this average drops to 5% in the post 1980's cycles when rates had less room to fall, though still impressive. Not surprising, US Treasuries and US agency mortgage-backed debt outperform credit markets. While, investment grade (IG) corporate and municipal bonds outperform high yield (HY) and preferred stock. US dollar-denominated emerging market debt has also fared well as the Fed eases.
- **What does a Fed rate cut mean for future fixed income returns?** As the standard disclaimer states, "past performance is no guarantee of future results". Currently, 20% of the developed world's IG bond market has a negative yield, while 75% (ex-USD) have a yield below 1%. In other words, the starting point for the next potential easing cycle would be the lowest on record. This implies that future returns are not likely to be as robust as past cycles, unless US yields turn negative. In addition to the economic outlook, future returns may also be impacted if policymakers react more to trade developments.
- **Call to action:**
  1. **We continue to recommend adding duration to balance portfolio risks.** High quality US IG corporate bonds or US municipals (for US investors) are our preferred vehicles, where yield and spread curves are relatively steep.
  2. **Play defense. Favor US HY bank loans over HY bonds.** HY bond spreads are tight and bank loans tend to exhibit lower price volatility during periods of risk off.
  3. **Overweight EM USD debt, where valuations are not excessively expensive.** We believe EM markets are better positioned to withstand a surprising rise in volatility.

Figure 1. Fixed income total returns, 12-months after first Fed rate cut

	Total Return After First Fed Cut (Forward 12 Months)						
	Sep-84	Jun-89	Jul-95	Sep-98	Jan-01	Sep-07	Average
US Agg	24.9%	11.1%	5.0%	2.0%	8.4%	4.4%	**9.3%**
US Treasury	23.1%	10.5%	4.5%	0.8%	6.7%	9.3%	**9.1%**
US Treasury short	18.3%	10.4%	5.5%	4.6%	8.5%	6.7%	**9.0%**
US Treasury intermediate	21.5%	10.5%	4.9%	3.1%	8.4%	8.3%	**9.4%**
US Treasury long	29.0%	10.7%	3.3%	-4.3%	4.3%	10.3%	**8.9%**
US TIPS				4.0%	7.9%	7.6%	**6.5%**
US MBS	29.4%	12.6%	5.9%	3.5%	8.2%	7.8%	**11.2%**
US Munis	15.5%	8.3%	6.6%	0.5%	5.1%	-0.4%	**5.9%**
US IG Corp	27.5%	10.8%	5.1%	1.8%	10.3%	-6.1%	**8.2%**
US IG Corp short	17.9%	11.8%	6.2%	5.4%	9.4%	1.2%	**8.7%**
US IG Corp intermediate	22.7%	10.7%	5.3%	3.3%	9.6%	-4.6%	**7.8%**
US IG Corp long	30.7%	10.9%	4.8%	-1.0%	12.2%	-8.2%	**8.2%**
US Corp AA-rated		10.7%	4.7%	2.1%	10.8%	-3.9%	**4.9%**
US Corp A-rated		11.1%	5.1%	1.3%	10.7%	-9.2%	**3.8%**
US Corp BBB-rated		11.3%	5.3%	1.8%	9.7%	-3.6%	**4.9%**
US IG Financials	24.8%	10.0%	5.6%	2.6%	10.9%	-13.5%	**6.7%**
US IG Industrials	27.3%	11.2%	5.0%	0.7%	10.8%	-0.2%	**9.1%**
US IG Utilities	29.0%	11.6%	4.5%	2.3%	5.9%	-0.9%	**8.7%**
US HY Corp			9.7%	3.3%	5.3%	-8.9%	**2.4%**
US Corp BB-rated	27.6%	9.3%	8.3%	4.4%	11.9%	-3.6%	**9.7%**
US Corp B-rated	23.6%	-0.6%	10.3%	3.0%	2.7%	-9.4%	**4.9%**
US Corp CCC-rated	4.4%	-16.3%	16.5%	1.1%	-4.0%	-15.1%	**-2.2%**
US Fixed Rate Preferreds		4.5%	7.8%	3.4%	9.8%	-38.4%	**-2.6%**
Global Agg, Unhedged USD			4.2%	3.2%	1.6%	5.1%	**3.5%**
Global Agg, Hedged USD			7.9%	2.9%	7.2%	3.6%	**5.4%**
Euro Agg				2.6%	6.1%	2.4%	**3.7%**
Euro IG Corp				2.6%	6.4%	-4.0%	**1.7%**
Euro HY Corp						-14.5%	**-14.5%**
EM USD EMEA				54.6%	36.9%	1.8%	**31.1%**
EM USD Latam				3.1%	6.8%	3.6%	**4.5%**
EM USD Asia				46.6%	25.7%	3.9%	**25.4%**

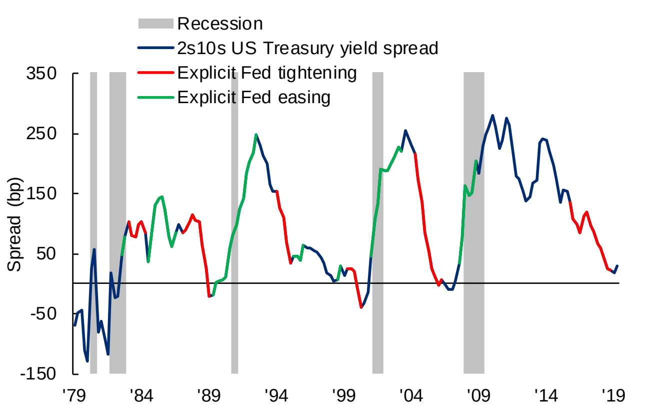
Source: Bloomberg Barclays Indices, FactSet as of June 27, 2019. Past performance is no guarantee of future results. Real results may vary. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only

Figure 2. US rate moves, 12-months after first Fed rate cut

	Yield start levels and change (bp) 12 month after first Fed Cut													
	Sep-84		Jun-89		Jul-95		Sep-98		Jan-01		Sep-07		Avg	
	Begin yield	Change (bp)	Begin yield	Change (bp)	Begin yield	Change (bp)	Begin yield	Change (bp)	Begin yield	Change (bp)	Begin yield	Change (bp)	Begin yield	Change (bp)
Fed Target (upper bound)	11.50	-350	9.81	-156	6.00	-75	5.50	-25	6.50	-475	5.25	-325	7.43	-234
3-month US T-bill yield	11.06	-379	8.92	-92	5.60	-42	4.96	-8	5.89	-415	4.01	-309	6.74	-208
2yr US Treasury yield	12.54	-366	8.82	-58	5.79	32	4.91	72	5.11	-204	4.15	-215	6.89	-123
5yr US Treasury yield	12.77	-304	8.65	-30	5.98	49	4.91	87	4.99	-61	4.25	-127	6.93	-64
10yr US Treasury yield	12.79	-248	8.60	-17	6.21	52	5.05	85	5.12	-5	4.54	-69	7.05	-34
30yr US Treasury yield	12.51	-194	8.60	-19	6.63	27	5.30	76	5.46	2	4.83	-52	7.22	-27
3m10y US yield curve	173	131	-32	75	61	94	9	93	-77	410	53	240	31.17	174
2y10y US yield curve	25	118	-22	41	42	20	14	13	1	199	39	146	16.50	90

Source: Haver Analytics as of June 27, 2019. Past performance is no guarantee of future results. Real results may vary.

Figure 3. Curve steepens during Fed easing cycles



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