

PERSPECTIVES

MONETARY POLICY IN THE U.S. IS BEING DETERMINED BY EUROPEAN (JAPANESE) FINANCIAL MARKETS

September 4, 2019

Topics: <u>Market and Economics</u> Contributors: Jess B. Yawitz, PhD



Subscribe to NISA Perspectives, Primers, News and Quarterly Economic Webinar Updates.

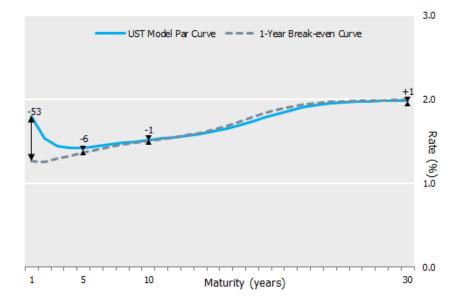
As we approach the next Fed meeting in September, expect more chatter on 1) whether they should ease and 2) what the inverted Treasury yield curve is saying about recession risk. Currently, the yield curve is shaped like a saucer. The highest rate is the 1-month bill, the lowest is the 5-year note, and the 30-year bond is only a few basis points below the front end.

The case for a Fed rate cut is obvious. The enormous fall in European sovereign yields, most into negative territory (mirroring Japan), has unleashed a wave of demand for dollar-denominated bonds from foreign real-money investors. As a result, Treasury yields have fallen over 100 basis points across the curve, except in the very short end where the fed funds rate anchors bill rates. The speed and size of the decline in Treasury yields has created this seemingly anomalous situation where bill rates are the highest yielding Treasury instrument.

What needs to happen? Markets anticipate a total of 100bps in Fed easing over the next year, bringing the fed funds rate to around 1.15%. Normally, expectations for such a large move would suggest the Fed is in a strong stimulatory phase. Not at all, this time. Due to no fault of their own (I have generally been critical of the Fed for much of the last 10 years), the European rates market has put the Fed behind the eight ball with a fed funds rate that is completely out of synch with the rest of the world.

So, the Fed has to ease to restore a semblance of sanity to the yield curve. In fact, with the fed funds rate at 1.15% and bill rates a bit lower, we would most likely have a fairly normal looking curve: upward sloping throughout but fairly flat given benign inflation expectations. This is approximately what forward rates are

pricing to occur over the next year, as shown in figure 1 below. The added benefit is it will stifle the media and talking heads on television that insist the inverted yield curve is forecasting a recession.



Sources: Bloomberg, NISA calculations.

One more point is worth noting regarding the significant stimulative effect on our economy from the dramatically lower rates that we have imported from offshore. The over 100bp fall in most borrowing rates this year have only been accompanied by a small decrease in inflationary expectations, implying most of the reduction is in real borrowing costs. Keep in mind this is across the entire maturity spectrum. I expect that this stimulus will far exceed what the Fed could have accomplished had it reduced fed funds proactively rather than reactively.

Disclaimer: By accepting this material, you acknowledge, understand and accept the following:

This material has been prepared by NISA Investment Advisors, LLC ("NISA"). This material is subject to change without notice. This document is for information and illustrative purposes only. It is not, and should not be regarded as "investment advice" or as a "recommendation" regarding a course of action, including without limitation as those terms are used in any applicable law or regulation. This information is provided with the understanding that with respect to the material provided herein (i) NISA is not acting in a fiduciary or advisory capacity under any contract with you, or any applicable law or regulation, (ii) that you will make your own independent decision with respect to any course of action in connection herewith, as to whether such course of action is appropriate or proper based on your own judgment and your specific circumstances and objectives, (iii) that you are capable of understanding and assessing the merits of a course of action and evaluating investment risks independently, and (iv) to the extent you are acting with respect to an ERISA plan, you are deemed to represent to NISA that you qualify and shall be treated as an independent fiduciary for purposes of applicable regulation. NISA does not purport to and does not, in any fashion, provide tax, accounting, actuarial, recordkeeping, legal, broker/dealer or any related services. You should consult your advisors with respect to these areas and the material presented herein. You may not rely on the material contained herein. NISA shall not have any liability for any damages of any kind whatsoever relating to this material. No part of this document may be reproduced in any manner, in whole or in part, without the written permission of NISA except for your internal use. This material is being provided to you at no cost and any fees paid by you to NISA are solely for the provision of investment management services pursuant to a written agreement. All of the foregoing statements apply regardless of (i) whether you now currently or may in the future become a client of NISA and (ii) the terms contained in any applicable investment management agreement or similar contract between you and NISA.