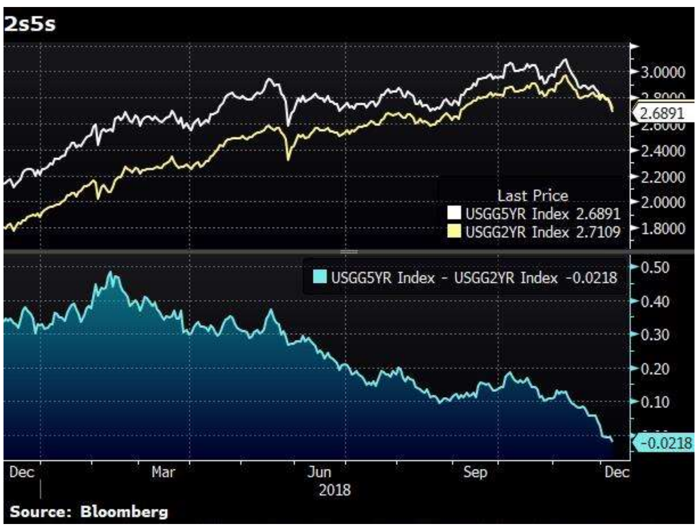
Insights

December 10, 2018

A Cautious Fed in the Year of the Pig

A presumed trade armistice between the US and China led to a rally in risk assets to start December. However, the optimism was short lived as comments from the US trade representative, tweets from the President, and deafening silence from Chinese authorities caused market participants to question to what extent a truce was reached. The persistent lingering of geopolitical issues that have seemingly reached maximum escalation only find new ways to further intensify driving volatility in markets and a stronger bid for risk-free assets.

While we acknowledge the real possibility that both sides reach an impasse that extends into 2019, we think the Chinese are ready to deal given the prospects for slower economic growth and weaker equity markets that are both crucial for promoting social stability. The Lunar New Year, which falls in early February this year, will be critical for setting the tone for the rest of the year for the Chinese people, and tariffs for essential staples such as pork (2019 will be the year of the pig) and soybeans during the holiday season are likely top of mind for the government.



The stronger bid for intermediate and longer term treasuries ran up against 2-year notes that were already pricing in a mostly certain Fed fund rate hike in December of this year and at least one more during 2019. The rally resulted in the 2s5s curve inverting and the 2s10s spread briefly touching a post-crisis low of 9bps intraday.

A firm resolution in trade negotiations would likely cause the curve to steepen. For longer rates, deficit funding, the Fed's balance sheet normalization, and higher yields in Europe and Japan are all factors that should limit how much yields can fall. At the same time, softer inflation expectations and historically modest wage pressure are likely to reduce Fed officials' median forecast of three rate hikes in 2019 as the four rate hikes in 2018 have already pushed the real effective Fed funds rate above zero.

The market is already discounting the Fed's stated willingness to hike with Fed fund futures only pricing in one hike through the end of next year. The upcoming FOMC meeting may provide markets with more clarity on the pace of additional hikes, so whether the Fed continues to tap the brakes on higher yields or stop more abruptly remains to be seen. We expect the Fed will be cautious, but in the meantime, expect more volatility and low yields.