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Q&A: Interest rate discussion and forecast

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Kris Moreton sits down with Ed Al-Hussainy to discuss what's happening now with interest rates — and what we could expect in the future.

Kris: The Federal Open Market Committee (FOMC) made the decision to cut the fed funds rate by another 25 basis points in late October. And since then, language across Fed governors has become uniformly more constructive on the state of the economy. But because broad economic data continues to be mediocre at best, it appears that the Fed is putting a lot of weight on a trade deal coming through. Tell us, Ed, what do you think are the key takeaways from the rate cut?

Ed: For the entire year, we've seen the FOMC try to get comfortable with easing rates in response to an environment of weakening growth and very little inflation. Two things stood out to me as quite notable with their last decision. First, rather than stressing the downside risks to growth and inflation, their outlook is more balanced — so they've cut this time with a view of remaining on hold for the foreseeable future. And second, there's a view that rates are now appropriately accommodative, which means, again, that they think they've bought enough insurance going to stay on hold into 2020.

Going into 2020, it's pretty clear that they're placing the emphasis on cyclical factors, which could potentially be solved with a short precautionary easing cycle, versus structural factors, which could require a lot more easing.

Kris: Do you expect additional rate cuts?

Ed: It's hard to say with a high degree of certainty. Over the next six to 12 months, the market is pricing in a 10% chance of one more cut, but I don't think the data has improved sufficiently to justify those low odds. I think, at best, that things in the U.S. economy are deteriorating at a slower pace. Outside of the U.S., the data continues to weaken, and there's no certainty of a trade deal (which, as you mentioned, the Fed seems to be expecting). Looking at the current mix, I'm fairly comfortable saying that additional cuts may be possible.

Edward Al-Hussainy
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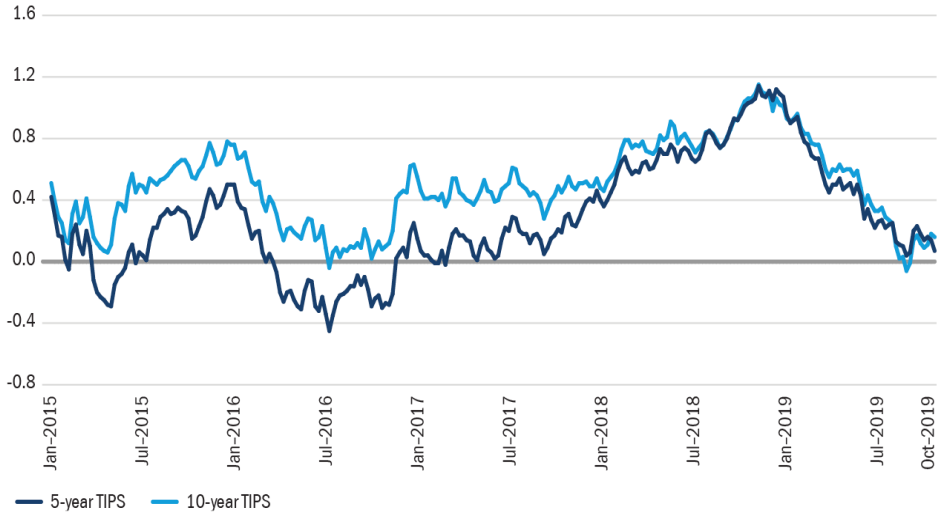
Kris: Do you think a zero percent fed funds rate or negative yields across the curve are a possibility in the U.S.?

Ed: It's easy to see us getting to a zero fed funds rate, and I think that there is a high likelihood of it happening in the next five years. The Fed only has about 100 basis points to go in terms of cuts before getting to zero, and the odds that they will have to use that in the next down cycle are high. Going forward, I suspect that every time we experience a period of distress, the Fed may have to bring the fed funds rate down to zero. I think this may become the norm in Fed policymaking.

Real rates (inflation-adjusted yields) are already at zero. Yields are zero to negative in any given week for Treasury inflation-protected securities. There's a very strong global component driving yields, and it's to the downside. At the moment, there's no evidence that global interest rates have reversed or stabilized. I think the force of gravity on the long end of the Treasury curve continues to be down.

Zero real rates are already a reality

5-year and 10-year Treasury inflation-protected security yield (%)



Source: Board of Governors of the Federal Reserve System: January 1, 2015 through October 25, 2019.

Kris: Given that the Fed doesn't have a lot of room to make cuts, does fiscal policy need to step in and do the heavy lifting?

Ed: That's a great question, and we're struggling with it — not just here in the U.S., but in Europe as well. Unlike the European Central Bank and the Bank of Japan, the Fed has no appetite for taking the fed funds rate to negative territory. Given that, I think that in addition to fiscal stimulus we may see unconventional aspects of monetary policy come into play — more quantitative easing and employing the Fed's balance sheet aggressively. I believe there will be a pretty intense debate over what goes on to that balance sheet: whether they should be buying corporate debt, buying equities, returning to the mortgage-backed market — all of it will be up for discussion.

Kris: Let's say that the Fed is successful in reigniting the economy and the data does turn more positive. What impact does the U.S. presidential election have on any potential actions by the FOMC? Can they hike rates heading into an election?

Ed: Historically, the Fed has been quite reluctant to hike in the six months ahead of

elections, and it's likely to exercise that that caution again. When we think about the next 12 months or so, the odds of them hiking, even if data returns to a very healthy place, remain very small. And in terms of market expectations, odds of a hike are now zero.

Kris: One last question for you, Ed. What is your forecast on the 10-year Treasury today?

Ed: We've had the 10-year at about 2% for the last six months. We haven't changed our forecast much, but looking out six to 12 months, it's more skewed to the downside than the upside.

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