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# INTEREST RATE OUTLOOK

## Conversation with Ed Al-Hussainy

Kris Moreton: The Federal Open Market Committee (FOMC) recently made its third 25 basis point cut to the federal funds rate. What are the key takeaways from that move for you?

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

In looking at how to balance structural factors, which could require a lot more easing, and cyclical factors, which could potentially be solved with a short precautionary easing cycle, it’s pretty clear that they are placing the emphasis on cyclical factors going into 2020.

Moreton: Do you expect another rate cut in December?

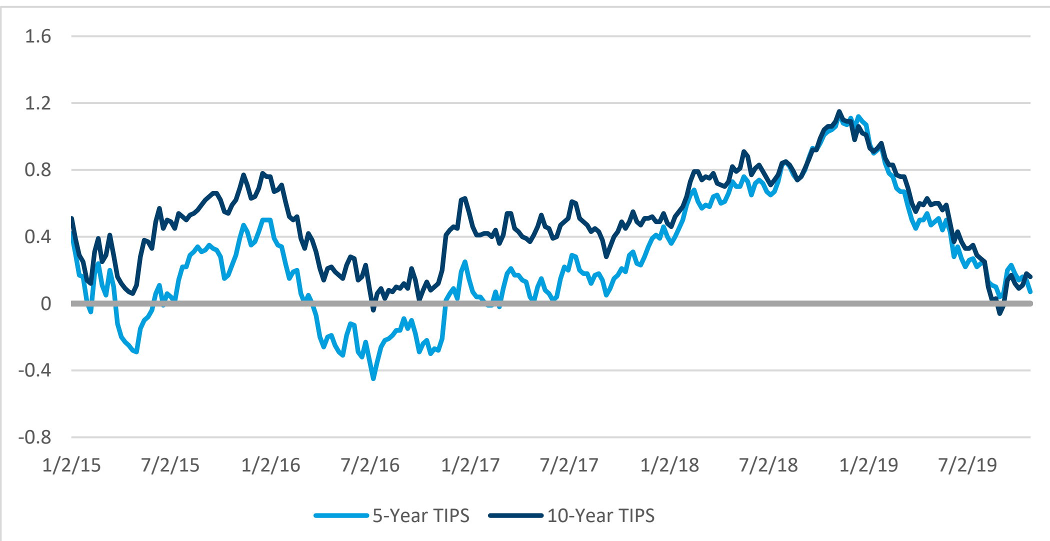
**Al-Hussainy:** It's difficult to have a high degree of certainty. Over the next 6 to 12 months, the market is pricing in a 10% chance of one more cut. I don't think the data has improved sufficiently to justify such low odds. At best, what we can say about the U.S. economy is that things have been deteriorating at a slower pace. Outside of the U.S., the data continues to weaken, and there is no certainty of a China trade deal, which the Fed seems to be expecting. I'm comfortable looking at the current environment and thinking that the Fed will be brought back to the table.

Moreton: Do you think a zero percent federal funds rate or negative yields are a possibility in the U.S.?

**Al-Hussainy:** It is easy to see us getting to a zero federal funds rate, and there is a high likelihood of that 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 are high that they will have to use that in the next down cycle. Going forward, I suspect that every time we experience a period of distress, the Fed may have to bring the fed funds down to zero. That may become the norm in Fed policymaking.

Real rates—inflation adjusted yields—are already at zero. For Treasury Inflation Protected Securities (TIPS), yields are zero to negative in any given week. There's a very strong global component driving yields and it is to the downside. There's no evidence that global interest rates have reversed or stabilized at the moment. The force of gravity on the long end of the Treasury curve continues to pull it down.

**Exhibit 1: 5-Year and 10-Year Treasury inflation-indexed security yield**




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

Moreton: 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?

**Al-Hussainy:** That's a great question, and governments are struggling with it at the moment, not just here in the U.S., but in Europe as well. Ultimately, it depends largely on the appetite in Congress to roll out fiscal stimulus.

Unlike the European Central Bank and the Bank of Japan, the Fed has no appetite for taking the federal funds rate to negative territory. Given that, in addition to fiscal stimulus, we may see the more unconventional aspects of monetary policy come into play—more quantitative easing and employing the Fed's balance sheet aggressively. What goes on that balance sheet will be an issue of pretty intense debate. Whether they should be buying corporate debt, buying equities or returning to the mortgage-backed market will all be up for debate.

Moreton: What impact does the U.S. presidential election have on any potential actions by the FOMC? Can they hike rates heading into an election?

**Al-Hussainy:** Historically, the Fed has been quite reluctant to hike in the six months ahead of elections, and it's likely to exercise 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.

Moreton: What is your forecast on the 10-year Treasury today?

**Al-Hussainy:** We've had the 10-year at about 2% for the last six months. We haven't changed our forecast much, but at the moment, looking out 6 to 12 months, it is more skewed to the downside than the upside.

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