Rate Cuts Will Embolden Trump's Trade Wars

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by: Samantha LaDuc

Summary

- The Fed has created a lot of volatility in the markets.
- The MOVE index is on the move, increasing 100% since March 20th.
- The market will trade sideways to lower into 2020.
- There is a rally in safe-haven assets, but equities are not budging.

The S&P 500 index is up ~17% YTD, pushing its record highs. This is in the face of trade wars and tariffs, overseas tensions, and strong performance from treasuries, gold, and the U.S. dollar.

The market is betting on an easy Fed. Words like "patient", "flexible" will drive the market performance and are important to hear. The Fed has created a lot of volatility recently!

Treasury volatility is already speaking volumes, popping up to 80 as of June 17. This could be because term premium is trading at a discount for the first time in fifty years, suggesting that those selling volatility had to hedge themselves by going long Treasuries. This “Bond Convexity” could be the reason for the recent 100bp move over the past 6 months.
Source: MOVE

The above graph shows the Merrill Lynch Option Volatility Estimate (MOVE) Index, which tracks the implied volatility of U.S. Treasurys over the coming month, based on their prices in the derivatives market.

Back on March 20, I wrote:

 Brace for impact!
 $MOVE

Source: Author

Seven days later, I wrote:

"Treasury Volatility caused the 10-year yields to crash which further inverted the yield curve because those who got caught selling volatility had to hedge by effectively going long Treasuries."
Fast forward to today. MOVE has risen almost 100% from 42.53 on March 20 to over 80 as of right now. Judging from the MOVE chart, we aren't done! As shown in the chart above, there is room for MOVE to continue to break upwards. If it continues higher, it would expose the market to significant downside risk.

**Inversion: Does it Lead to the R-Word?**

The rally in safe-haven assets reflects the worries that the market doesn't know how bad things are yet. Will we have a massive sell-off, and will the bull market be at risk? My thinking: we will be trading sideways-to-lower into 2020.

Economic data have given a false sense of calm to the market. There is risk that is not yet priced into stocks, including, but not limited to, the Trade War. The 3-month/5-year curve, pinpointed by economist Cam Harvey as a key recessionary indicator once it inverts for a full quarter, has just finished a full quarter being inverted.

![Chart showing the relationship between USGG5YR Index and USGG3M Index](image_url)

*Source: Lisa Abramowicz*
Couple this with the descending wedge on the 10-year bond, which suggests a potential break-out, yields are more than likely going to fall further this summer, especially after a suitable bounce off the red trend line. The bond market is indicating the possibility that 10-year rates are going lower to 2.0%.

Source: Interactive Brokers

**How Did We Get Here?**

Interest rates are now pricing in almost two full cuts in the Fed Funds target rate before the end of the year. The Fed Funds future for January 2020 implies an expected rate of 1.95%, compared to the current rate of 2.39%, and the target of 2.25–2.50%. The yield curve is flirting with inverted territory, with 10-year note rates 9 bps below 3-month bills.
Source: FRED

The U.S. Treasury Yield Curve inversion is anticipating the highest likelihood of a recession since 2007, with recession risk well above levels that preceded recessions in 2001 and 1990. Powell acknowledged “inflation shortcomings” in his most recent speech, which could be a signal that he is prepared to accommodate the market.

**Globally: Easing vs. Tightening**

There is criticism that the Fed has already over-tightened. The Fed shrank its balance sheet by $500B over the past year and a half, and has been hiking rates steadily over that same time period. No other country has tightened at such a rapid pace, and most global central banks are beginning to enter into rounds of easing.
Source: Willie Delwiche

In comparison, the Fed has tightened considerably this cycle. That could be why the bond market is aggressively leading the anticipated rate cut, and why both the bond and equity markets are interpreting it as recessionary. Everything is done in extremes.
Source: Bloomberg

What Will Happen Next?

This dramatic fall in yields doesn’t look done — either from the above Treasury Volatility MOVE chart (breaking up) or the bond market intoning 10-year rates are going lower to 2.0% this summer. It wouldn’t surprise me to see 1.75% by the end of the year.

The last time that U.S. 10-year government bond yields were at the 2.25% level, the Fed Funds rate was half of its current level, sitting at 1.25% in Q3’17. As the disconnect between what the market judges to be the appropriate interest rate versus what the Fed judges it as, is primarily what is driving the yield curve inversion.

I believe that the market will have a knee-jerk reaction higher if we do see a rate cut, but things will subsequently move lower following. Driving up assets on bad data is not a winning strategy, and the cracks in the façade will continue to widen moving forward.

The latest data from the futures market shows a 100% chance for July and 76% for September. They even see a cut for December. A month ago, traders saw a 9% chance of two rate cuts by September.

Lisa Shalett, Morgan Stanley's (NYSE:MS) Chief Investment Officer stated:
In less than six months, investors have gone from discounting three Fed rate hikes to three cuts; many factors support the shift, but we question whether easing alone can change the outcome. While looser policy may support market liquidity and valuations in the short run, we are not confident that rate cuts can cure what ails the economy. All-time high consumer confidence, 50-year low unemployment and mortgage rates near 4% have not lifted consumption and residential investment; rather, policy uncertainty from Washington and geopolitical instability is weighing on the aging business cycle; trade uncertainty appears to be distorting supply chains, quashing capital spending and contributing to a manufacturing slowdown. If the Fed is ultimately pressured into “prophylactic rate cuts,” then it may find itself with too few bullets left when it really needs them, she added.

What Wall Street wants is an accommodating Fed that will help push the market to more all-time highs. There are several scheduled economic releases for next week, including housing starts, jobless claims, and existing home sales.

The Fed will more than likely wait until the July meeting to make the "big" announcement, given the timing of the G20 meeting and the June 24th Chinese Tariff deadline. Trump will also have the Mexico tariffs as a potential negotiation card on his end. Then they will have a more urgent reason to cut.

Until then, we are on a path speeding towards isolationism, which is dangerous for the economy and the market. Trade wars are not an easy thing to win, and they will severely impact our economy, and put us at risk of a global recession. The only entity that appears to have any sway in convincing Trump of this is the Fed.

Disclosure: I/we have no positions in any stocks mentioned, and no plans to initiate any positions within the next 72 hours. I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it (other than from Seeking Alpha). I have no business relationship with any company whose stock is mentioned in this article.

Comments (10)

csymalla
Love your writing, data, and perspective. Great look at the current state of the markets.

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