Viewpoints

Interest rate policy - kicking the can down the road?

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Global Fixed Income

Interest rate policy - kicking the can down the road?

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"Cutting rates now would likely give markets a short-term boost by extending the current cycle."

Boston - Not too long ago, markets were trying to reconcile how many times the Fed would hike interest rates in this current cycle. However, the focus has recently shifted with softer growth readings, lower job prints and volatility from trade tensions dominating the news flow.

Market participants are now concentrating on the June FOMC meeting (18th and 19th), trying to work out how the Fed officials will interpret the recent weakness in economic data and the effects of lingering trade tensions on the overall growth picture. One look at Fed Fund Futures (a market indicator on expectations for short-term interest rates) shows that there are strong expectations for the next move in interest rates to be lower.

FOMC meeting	Probability of an interest rate cut
June	14%
July	76%
By the end of the year	97%

Source: Eaton Vance, Bloomberg, 12 June 2019

The market however, has not been a good predictor of what the Fed will actually do and history shows numerous examples of interest rates not following the path expected by markets.

The Fed faces the difficult balancing act of addressing weaker data without compromising its ability to soften the landing if matters take a turn for the worse down the road. In addition to this, one eye needs to be kept global economic developments as we have seen data in Europe weaken relative to the US.

Chairman Powell has yet to suggest cutting rates although he did state that the central bank would "act as appropriate to sustain the expansion".

The impact on high-yield corporate bond markets

Cutting rates now would likely give markets a short-term boost by extending the current cycle.

If the Fed responds to a weakening growth outlook by cutting rates, the impact on the broader fixed income markets and on the fundamental health of high yield issuers should be positive, as the current cycle elongates. Lowering rates could stimulate consumer demand by increasing access to credit, possibly counteracting any drag on consumption from tariffs.

Cutting rates could assist high-yield issuers by:

- lowering borrowing costs;
- helping to decrease leverage levels; and
- increasing interest coverage.

It may potentially act as a catalyst to boost both supply and demand, with increased primary issuance and further inflows into the asset class as investors search for higher yields relative to US Treasuries and other investment-grade markets. 2019 has already seen a big reversal of last year's high-yield outflows in favor of floating-rate loans products and expectations for looser monetary policy is set to continue that trend.

Two big risks to cutting interest rate prematurely, or too quickly, are:

1. Inflation. With CPI currently close to the Fed's 2% long-term target, investors have not been worried about inflationary pressure for some time. However, high yield issuers have recently acknowledged that the rising costs of inputs and wages have squeezed earnings, with increases in Producer Price Index (PPI) one of the more tangible knock on effects of tariffs.
2. An increase in the overall level of debt in the economy, both at a corporate or household level.

Fortunately, fundamentals continue to remain supportive and stable for the high yield market, with the exception of the energy sector, which has experienced some recent deterioration due to the decline in oil prices.

Despite high yield credit spreads currently below their historical averages, defaults continue to remain benign and we expect them to stay below the long-term average over the near future.

With interest rate cuts, the Fed has the ability to greatly impact markets over the short term from a technical perspective, potentially fueling increased demand for the asset class and stimulating a healthier primary issuance calendar. More notable are the medium term impacts of Fed decisions that can have a meaningful effect on financial conditions and the subsequent repercussions on corporate balance sheets.

Bottom line: Despite market uncertainty, US-China trade relations or central bank decisions, it is more important to carefully focus on issuer fundamentals and valuations at this stage in the cycle.

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