Quick Glance – US Rates

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How is the Federal Reserve dictating 2020 Economic Outlook?

It is all about the Federal Reserve (FED)! In the past few months, Donald Trump has tweeted countless times his frustration with the FED decisions on interest rates, by stating it has been 'way too fast to raise, and way too slow to cut!'. On the other hand, Jerome Powell is strongly committed to maintaining a 2% inflation rate while providing the market with further quantitative easing in order to suppress a potential repo market crash. As per *figure 1,* we can see many indications of an economic slowdown. The first indicator was the inverted yield curve followed by 25bps interest rate cut, which then was cut by a further 50bps post an unexpected repo rate spike that raised many eyebrows on how truly safeguarded the financial system is from another liquidity meltdown.

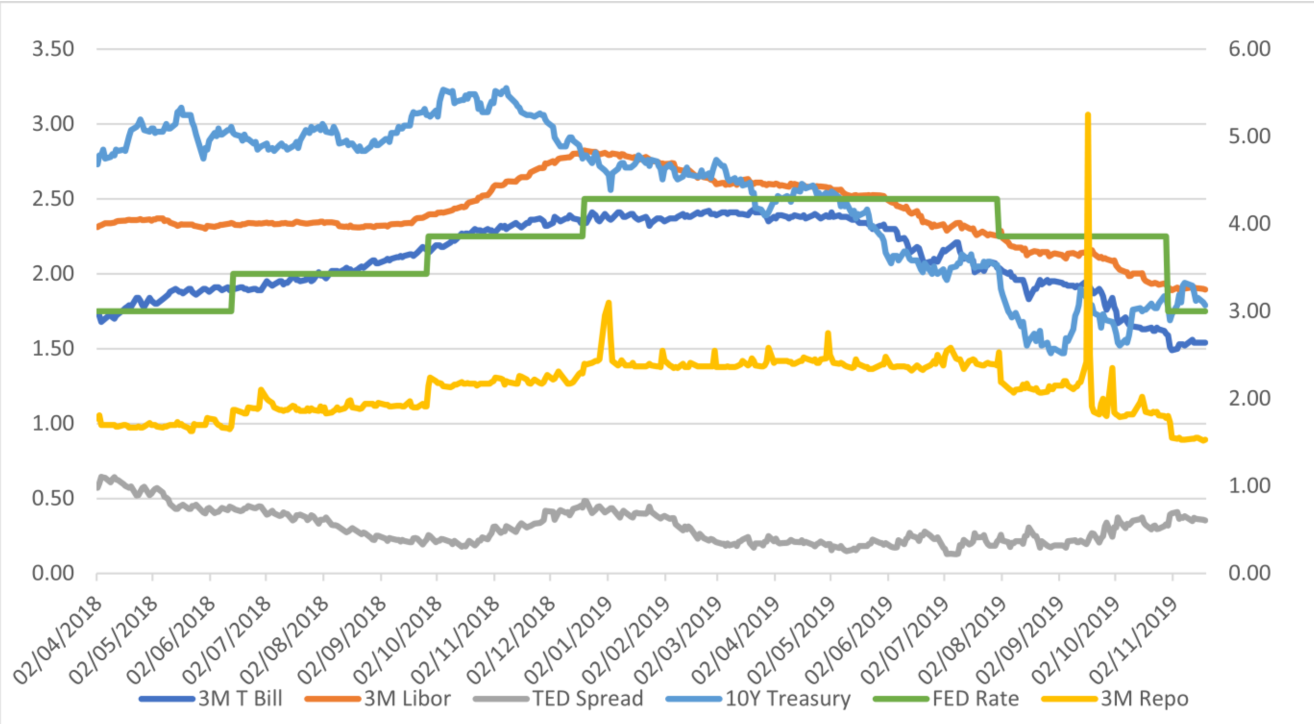

Figure 1: Summarised view of the short-term rate market from April 2018 to November 2019 against 10 Year Treasury and the Federal Reserve rate changes.

Historically speaking inverted yield curves suggest that markets expect a recession, although the timing is uncertain. Another crisis gauge, the repo market, channels more than $1 trillion in funds every day, typically used to raise short-term capital – which is likely to spike when liquidity dissipation is caused by lenders suspicion of borrowers' collateral quality.

US Interest Rates Landscape as of 5th February

Following the US – Iran tensions peak in January, we have seen an unexpected outbreak of a new Coronavirus named 2019-nCoV in Wuhan, China – a city with a population of over 11 million people. Despite the lower fatality rate of 2.1% in comparison to previous Coronavirus outbreaks, such as a rate of almost 10% for SARS (Severe Acute Respiratory Syndrome) and 35% MERS (Middle East respiratory syndrome related coronavirus), 2019-nCoV has had almost 25,000 confirmed cases in over 20 countries. The World Health Organization (WHO) declared global emergency following the Chinese government decision to lockdown multiple cities in Hubei province, as a measure to contain the uncontrollable rate of infection. Emerging Markets were directly affected by the outbreak; however, we can also see in Figure 3 that the 30y Treasury yield fell to just over 200bps as the virus worries linger. The yield spread between the 2-year note and the 10y note maturity narrowed to around 17bps, indicating fears around the economy's outlook. Foreseeing a future slowdown of the infection – hence leading to a readjustment of the curve back to a level before the virus began making headlines, investors can profit from the change in the yield curve by going long 10y Treasuries and then positioning themselves for a re-steepening of the curve as the rate of infected falls below the rate of recovered individuals – such an outlook would be supported by scientists finding a vaccine for the virus. The current price levels also seem attractive after the small sell-off that happened two days ago. There have been some reports of a cure being found, although the WHO has downplayed the rumours. China has implemented measures to minimize the domestic impact of the virus via a reverse repo rate cut and a liquidity injection. Could this mean the US Treasury will follow suit? It may be a possibility, should the virus outbreak start seriously hampering economic activity abroad. The reports of a Chrysler plant in Italy having shortages of crucial parts that come from China may be the first large-scale indicator of this issue. Given the reliance on Chinese manufacturing in the global economy, this may turn into a real problem. Therefore, a dovish outlook for the US and a higher likelihood of a cut in 2020 are in the cards.

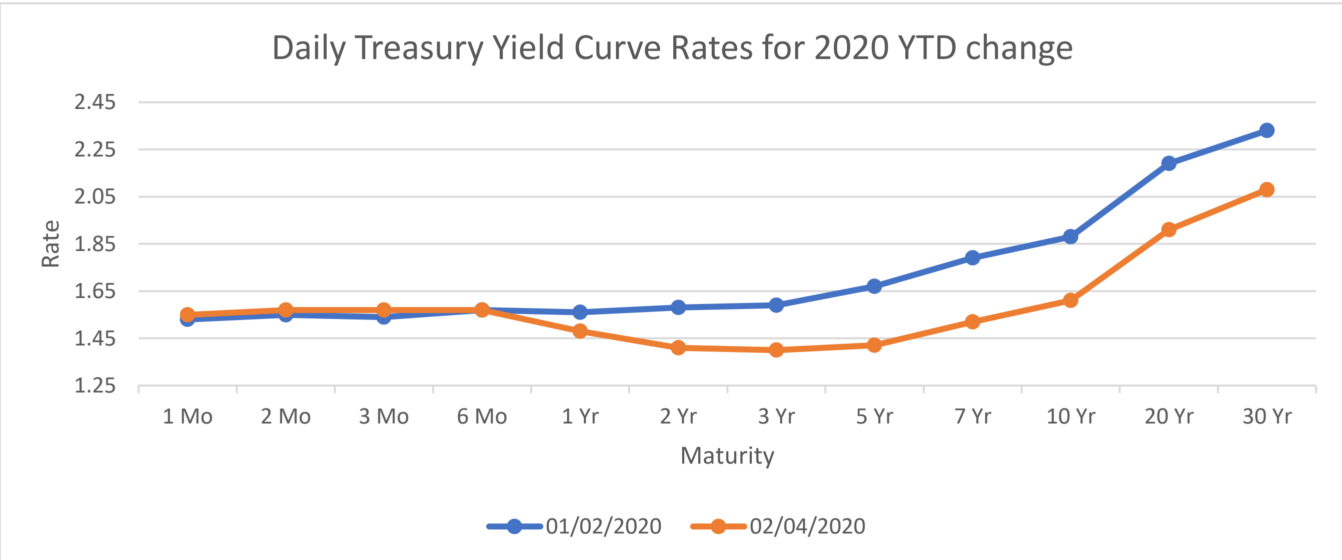

Figure 2: Daily Treasury Yield Curve Rates for 2020 Year To Date (YTD) change.