Return to zero

US Special

RaboResearch
Global Economics & Markets
mr.rabobank.com

Philip Marey
Senior US Strategist
+31 30 712 1437

Contents

Summary

- This year the Fed made a U-turn by abandoning its hiking cycle and making three insurance cuts. However, from here it will take a 'material reassessment' of the economic outlook to change the Fed's view that monetary policy is well calibrated after the three insurance cuts made this year.
- However, the same forecasting framework that helped us pinpoint the end of the Fed's hiking cycle in 2019 is also indicating that the three insurance cuts of this year will not be enough to prevent the economy from sliding into a recession by the summer of next year. Consequently, the Fed will have to cut rates all the way back to zero before the end of 2020.
- A resurgence of the trade conflict between the US and China, or other possible trade conflicts involving the US, could add to pressure on the Fed to cut rates next year, through a feedback loop between trade policy and monetary policy.
- Even if our baseline scenario of a recession is avoided, in the next most likely scenario of an economic slowdown we also expect the Fed going back to zero.
- At this stage, it still seems unlikely that the Fed will take its policy rates into negative territory.
- Meanwhile, we expect the Fed will continue to have to intervene in the money markets as the repo turmoil seems far from over and the effective federal funds rate is again pushed away from the midpoint of its target range.

The Fed's U-turn

It is easy to forget - and the Fed would like us to - that only a year ago, at the December 2018 meeting, the Fed had delivered its fourth rate hike of the year and intended to hike two more times in 2019. In reality, the Fed did not make a single hike this year and instead cut rates three times. Of course, we are not allowed to draw the conclusion that the Fed made a policy mistake in 2018 that it had to correct in 2019. In fact, during his post-meeting press conference on December 11, Powell said that what happened in 2019 was a surprise… Well, not to us. In fact, last summer we warned the Fed that it was taking its hiking path too far. In July 2018 (When will the Fed invert the yield curve?) we warned that if the Fed stuck to their rate projections they would invert the curve in 2019. In our view that would be a monetary policy mistake and a precursor to recession. Unfortunately, the Fed's confidence continued to grow and in October 2018 (The Fed's road to inversion) we concluded that the Fed was on a road to inversion, and would only stop until after inversion and finally end the hiking cycle after March 2019.

At this year's December meeting, Powell repeated that it will take a 'material reassessment' of the economic outlook to change the Fed's view that monetary policy is well calibrated after the three insurance cuts made this year. In fact, the dot plot indicates that the FOMC intends to remain on hold through 2020. Powell was rather dovish, stressing that there was less reason to hike than after previous mid-cycle adjustments in the 1990s because there is now less upward pressure on inflation. Nevertheless, the Committee expects the next move to be a hike, not another cut. The dot plot implies one hike in 2021, one in 2022, and one or two in 2023. (For more details we refer to Everything is under control.)

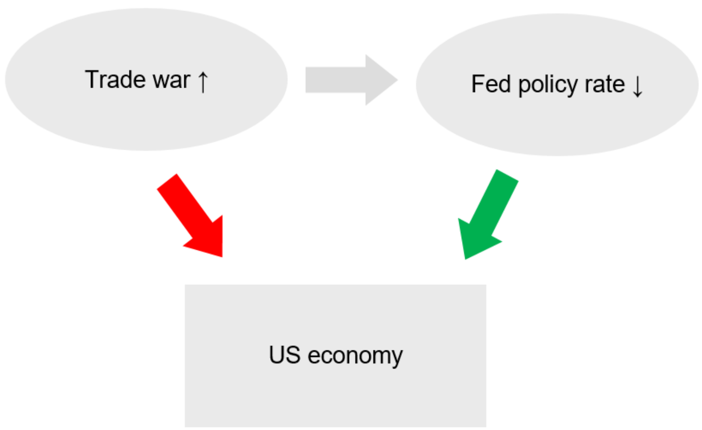
However, the Fed's U-turn in 2019 makes their current projections for 2020 questionable as well. Even worse, in the September 2019 dot plot they did not even anticipate their own October cut. So if they can't even anticipate their actions one month ahead, why should we believe their projections one year ahead?

In fact, the same forecasting framework that helped us pinpoint the end of the Fed's hiking cycle in 2019 is also indicating that the three insurance cuts will not be enough to prevent the economy from sliding into a recession by the summer of next year. Consequently, the Fed will have to cut rates all the way back to zero before the end of 2020. Therefore, we expect the FOMC to make this 'material reassessment' in the coming months. For more details on our forecasting framework and recession forecast we refer to last week's special The long and winding road to recession.

Will Trump take back the remote control?

A resurgence of the trade conflict between the US and China, or other possible trade conflicts involving the US, could add to pressure on the Fed to cut rates next year. It could re-establish the feedback loop between trade policy and monetary policy that we saw in recent months. This year the Fed responded to the trade policy uncertainty by making three insurance cuts of 25 bps each, in July, September, and October. As we pointed out during the summer, by linking the insurance cuts to trade policy, the Fed had virtually given President Trump a remote control of monetary policy. He already had some influence on monetary policy through the impact of trade measures on financial markets. However, by taking a risk management approach to trade policy uncertainty, the Fed has amplified the effect of trade policy on monetary policy. All Trump needs to do is raise tariffs or take another protectionist measure to get the Fed to cut rates further. In fact, the Fed is enabling the US administration to be tough on trade as the central bank has promised to offset any expected negative impact on the US economy by cutting rates in advance. This means that the Fed is bolstering Trump's bargaining position in the 'game of chicken' between the US and China that we analyzed a few years ago in The Trump Trade War Game. This also makes it more likely that President Trump will escalate the trade war again. And that will make it more likely that the Fed will cut rates. Consequently, there exists a strong feedback loop between trade policy and monetary policy that may add to the pressure on the Fed to cut rates in 2020. After three insurance cuts, by declaring an end to what the Fed thinks was a 'mid cycle adjustment', the central bank has temporarily taken away the remote control from President Trump. However, it is not difficult for him to get it back.

Figure 1: Feedback loop between trade policy and monetary policy



Source: Rabobank

Different roads lead to zero

While economics is not an exact science we think that the empirical evidence indicates that a recession is more likely than not. Therefore, we expect the Fed to cut all the way to zero. However, the next most likely scenario in our view is that the economy slows down without formally falling into recession. In this scenario, we also expect the Fed to cut to zero. Note that the Fed cannot know in advance if the economy is facing only a slowdown or a recession. However, given the limited amount of ammunition the Fed is likely to react rapidly and aggressively, once it realizes that the insurance cuts were not enough. In fact, the Fed's response may even help to prevent a recession from materializing. Paradoxically, the more aggressively the Fed cuts rates, the less likely a recession is to materialize.

Put differently, our forecast of the Fed going back to zero is a more robust forecast than the US economy going into recession, in the sense that we expect the Fed to return to the zero bound both in our baseline scenario where the economy falls into recession and in our second most likely scenario that the US economy experiences a significant slowdown while avoiding a recession.

While the Fed going all the way back to zero may sound like an extreme forecast, we should keep in mind that the Fed already made three cuts of 25 bps each with the economy still growing at 2.1% (second estimate of Q3 GDP growth). Six additional cuts when the economy slows down with the risk of a recession does not seem that extreme from this perspective.

Final destination zero, but not lower

While several central banks have taken policy rates into negative territory, the Fed continues to prefer central banking at nonnegative rates. Keep in mind that in 2008 the Fed tried everything but the kitchen sink to avert a second Great Depression. The kitchen sink was a negative rates policy. The Fed's aversion to negative rates is still strong more than a decade later. At the October meeting all FOMC participants judged that negative interest rates currently did not appear to be an attractive monetary policy tool in the United States. However, participants did not rule out the possibility that circumstances could arise in which it might be appropriate to reassess the potential role of negative interest rates as a policy tool. For now, we assume that the recession will not be deep enough to make the FOMC resort to negative rates. Our forecast of the Fed's path for the federal funds rate in 2020 is shown in table 1.

Table 1: Rabobank forecasts of FOMC decisions

FOMC meeting	*Decision*	*Target range for the federal funds rate (%)*
29 Jan 2020		1.50-1.75
18 Mar 2020		1.50-1.75
29 Apr 2020	25 bps slowdown cut	1.25-1.50
10 June 2020	25 bps recession cut	1.00-1.25
29 July 2020	25 bps recession cut	0.75-1.00
16 Sept 2020	25 bps recession cut	0.50-0.75
5 Nov 2020	25 bps recession cut	0.25-0.50
16 Dec 2020	25 bps recession cut	0.00-0.25

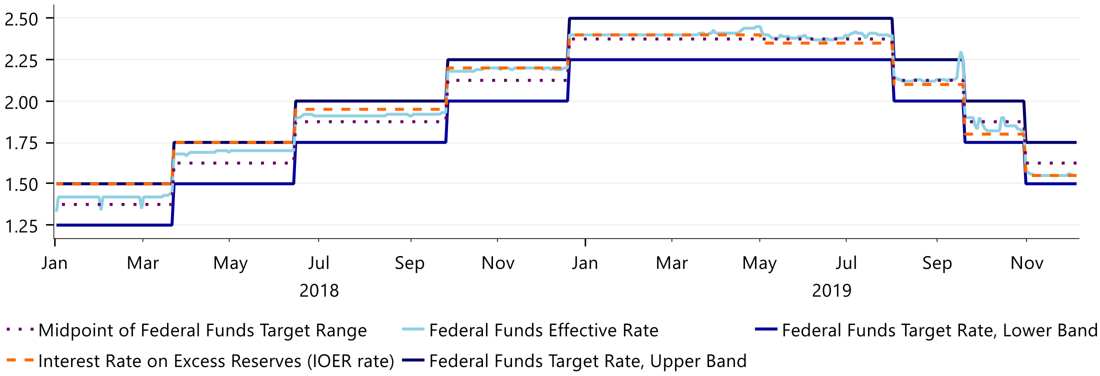
Source: Rabobank

Recurring trouble in the money markets

While the FOMC is taking a pause after three insurance cuts to the target range for the federal funds rate, the money markets continue to require intervention by the Fed. As we are approaching year end, stress in the repo markets has returned. However, at the post-meeting press conference in December Powell seemed a bit sanguine about the turmoil in the repo markets and said that temporary upward pressures were not uncommon year end, and they appear to be manageable.

As we have explained in Repo control, if the Fed does not develop better tools to control the repo markets - such as a standing repo facility -, it is only a matter of time before we get another episode of repo stress. However, Powell did not seem to be in a hurry to introduce a standing repo facility and said that the Fed was at the moment more focused on treasury bill purchases and looking into supervisory and regulatory issues affecting repo. However, he showed willingness to buy coupons, in addition to bills, in the balance sheet expansion program if necessary. The Fed may not see the urgency at the moment, but at least there is some flexibility. Let's hope they do not fall to far behind the curve again, as in September. We may still see some Fed action in the repo markets before and after year end, of course only 'technical.'

Figure 2: Fed funds rate and IOER rate



Source: Macrobond

Meanwhile, the balance sheet expansion and temporary repo operations are also pushing the effective federal funds rate down to the IOER rate, well below the midpoint of the target range for the federal funds rate (figure 2). Basically, this is the reverse of what we saw in 2018 and earlier this year, when balance sheet normalization (= reduction) played an important role in pushing up the effective federal funds rate within its target range. In response, the Board of Governors made three technical downward adjustments to the IOER rate relative to the target range for the federal funds rate in June 2018, December 2018 and September 2019. Now that the Fed is expanding its balance sheet again to stabilize the repo market, the opposite is happening. As the effective federal funds rate has fallen within its target range, an upward tweak to the IOER rate would be required. If the Fed remains on hold for the coming months as far as the target range for the federal funds rate is concerned, a tweak to the IOER rate may be the only action we may be looking forward to.

Our concern is that the Fed already has trouble stabilizing the money markets with the economy growing at about 2%. If a recession hits the economy, the stress in the money markets will only increase.

Conclusion

While the Fed thinks that 2020 will be a quiet year in terms of monetary policy, we fear that the U-turn they made in 2019 will be followed by a further decline to zero. Along the way, the money markets will continue to plague the Fed. If we are right, the longest economic expansion in recorded history will get us back to the start.

RaboResearch
Global Economics & Markets
mr.rabobank.com

Global Head

Jan Lambregts
+44 20 7664 9669
Jan.Lambregts@Rabobank.com

Macro Strategy

Europe

Elwin de Groot
Head of Macro Strategy
Eurozone, ECB
+31 30 712 1322
Elwin.de.Groot@Rabobank.com

Stefan Koopman
Market Economist
Eurozone, UK
+31 30 712 1328
Stefan.Koopman@Rabobank.com

Teeuwe Mevissen
Senior Market Economist
Eurozone
+31 30 712 1509
Teeuwe.Mevissen@Rabobank.com

Bas van Geffen
Quantitative Analyst
ECB
+31 30 712 1046
Bas.van.Geffen@Rabobank.com

Wim Boonstra
Senior Advisor
Germany
+31 30 216 2666
Wim.Boonstra@Rabobank.nl

Koen Verbruggen
Economist
France
+31 6 129 73 956
Koen.Verbruggen@Rabobank.nl

Alexandra Dumitru
Economist
UK, Ireland
+31 30 216 0441
Alexandra.Dumitru@Rabobank.nl

Maartje Wijffelaars
Senior Economist
Italy, Spain, Portugal, Greece
+31 30 216 8740
Maartje.Wijffelaars@Rabobank.nl

Michiel van der Veen
Economist
Eurozone
+31 6 831 34 616
Michiel.van.der.Veen@rabobank.nl

Americas

Philip Marey
Senior Market Strategist
United States, Fed
+31 30 712 1437
Philip.Marey@Rabobank.com

Hugo Erken
Head of International Economics
United States
+31 30 215 2308
Hugo.Erken@Rabobank.nl

Christian Lawrence
Senior Market Strategist
Canada, Mexico
+1 212 808 6923
Christian.Lawrence@Rabobank.com

Mauricio Oreng
Senior Market Strategist
Brazil
+55 11 5503 7315
Mauricio.Oreng@Rabobank.com

Asia-Pacific

Michael Every
Senior Market Strategist
Asia, Australia, New Zealand
+852 2103 2612
Michael.Every@Rabobank.com

Björn Giesbergen
Senior Economist
China, Japan
+31 30 216 2562
Bjorn.Giesbergen@Rabobank.nl

Hugo Erken
Head of International Economics
India
+31 30 215 2308
Hugo.Erken@Rabobank.nl

FX Strategy

Jane Foley
Head of FX Strategy
G10 FX
+44 20 7809 4776
Jane.Foley@Rabobank.com

Piotr Matys
FX Strategist
Central & Eastern Europe FX
+44 20 7664 9774
Piotr.Matys@Rabobank.com

Christian Lawrence
Senior Market Strategist
LatAm FX
+1 212 808 6923
Christian.Lawrence@Rabobank.com

Rates Strategy

Richard McGuire
Head of Rates Strategy
+44 20 7664 9730
Richard.McGuire@Rabobank.com

Lyn Graham-Taylor
Senior Rates Strategist
+44 20 7664 9732
Lyn.Graham-Taylor@Rabobank.com

Matt Cairns
Senior SSA Strategist
+44 20 7664 9502
Matt.Cairns@Rabobank.com

Credit Strategy & Regulation

Ruben van Leeuwen
Head of Credit Strategy
ABS, Covered Bonds
+31 30 712 1391
Ruben.van.Leeuwen@Rabobank.com

Vaclav Vacikar
Analyst
Financials
+31 30 712 1519
Vaclav.Vacikar@Rabobank.com

Hyung-Ja de Zeeuw
Senior Strategist
Corporates
+31 30 712 1555
Hyung-Ja.de.Zeeuw@Rabobank.com

Bas van Zanden
Senior Analyst
Pension funds, Regulation
+31 30 712 1869
Bas.van.Zanden@Rabobank.com

Cas Bonsema
Analyst
ABS
+31 30 712 1849
Cas.Bonsema@Rabobank.com

Energy Markets

Ryan Fitzmaurice
Energy Strategist
+1 212 916 7874
Ryan.Fitzmaurice@Rabobank.com

Agri Commodity Markets

Stefan Vogel
Head of ACMR
+44 20 7664 9523
Stefan.Vogel@Rabobank.com

Carlos Mera
Senior Commodity Analyst
+44 20 7664 9512
Carlos.Mera@Rabobank.nl

Michael Magdovitz
Commodity Analyst
+44 20 7664 9969
Michael.Magdovitz@Rabobank.com

Client coverage

Wholesale Corporate Clients

Martijn Sorber	Global Head	+31 30 712 3578	Martijn.Sorber@Rabobank.com
Hans Deusing	Netherlands	+31 30 216 9045	Hans.Deusing@Rabobank.com
David Kane	Europe	+44 20 7664 9744	David.Kane@Rabobank.com
Neil Williamson	North America	+1 212 808 6966	Neil.Williamson@Rabobank.com
David Teakle	Australia, New Zealand	+61 2 8115 3101	David.Teakle@Rabobank.com
Ethan Sheng	Asia	+852 2103 2688	Ethan.Sheng@Rabobank.com
Ricardo Rosa	Brazil	+55 11 5503 7150	Ricardo.Rosa@Rabobank.com

Financial Institutions

Eddie Villiers	Global Head	+44 20 7664 9834	Eddie.Villiers@Rabobank.com
Roeland Bronsveld	Benelux	+31 30 216 9030	Roeland.Bronsveld@Rabobank.com
Krishna Nayak	Germany, Austria, CEE	+44 20 7664 9883	Krishna.Nayak@Rabobank.com
Philippe Macart	France	+44 20 7664 9893	Philippe.Macart@Rabobank.com
Mauro Giachero	Italy	+44 20 7664 9892	Mauro.Giachero@Rabobank.com
Martin Best	UK, Scandinavia, Middle East	+44 20 7809 4639	Martin.Best@Rabobank.com
Paul Duddy	USA	+1 212 916 3799	Paul.Duddy@Rabobank.com
Wouter Eijsvogel	Treasury Sales Europe	+31 30 216 9723	Wouter.Eijsvogel@Rabobank.com
David Pye	Central Banks	+44 20 7664 9865	David.Pye@Rabobank.com

Capital Markets

Herald Top	Global Head of Capital Markets	+31 30 216 9501	Herald.Top@Rabobank.com
Nader Pasdar	Capital Markets USA	+1 212 808 6861	Nader.Pasdar@Rabobank.com
Adam Wotton	Capital Markets Asia	+852 2103 2629	Adam.Wotton@Rabobank.com
Willem Kröner	Global Head of Equity Capital Markets	+31 30 712 4783	Willem.Kroner@Rabobank.com
Crispijn Kooijmans	DCM FIs & SSAs	+31 30 216 9028	Crispijn.Kooijmans@Rabobank.com
Bjorn Alink	DCM Securitisation & Covered Bonds	+31 30 216 9393	Bjorn.Alink@Rabobank.com
Othmar ter Waarbeek	DCM Corporate Bonds	+31 30 216 9022	Othmar.ter.Waarbeek@Rabobank.com
Joris Reijnders	DCM Corporate Loans	+31 30 216 9510	Joris.Reijnders@Rabobank.com
Brian Percival	DCM Leveraged Finance	+44 20 7809 3156	Brian.Percival@Rabobank.com

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