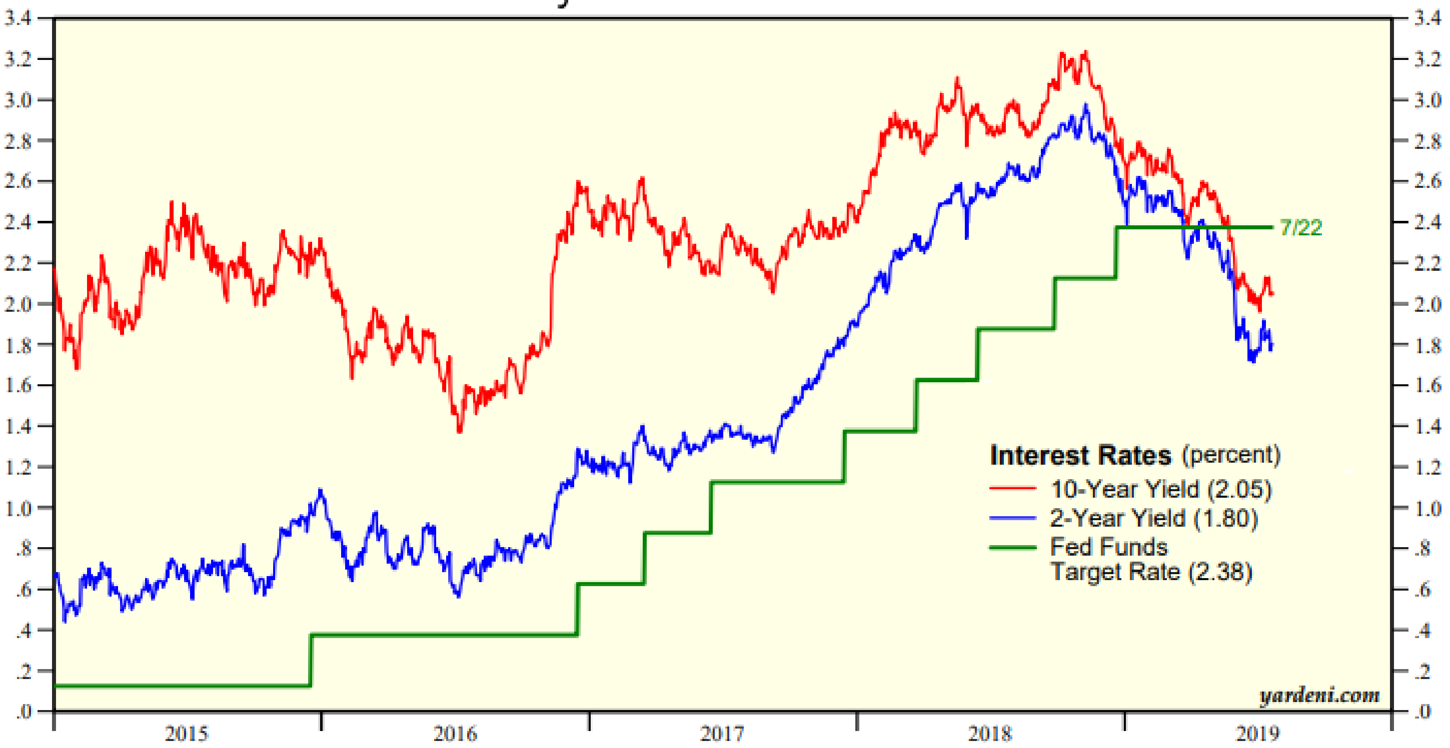
Chart of the Month

July 2019

U.S. Treasury Yields and Fed Funds Rate



Source: Federal Reserve Board.

The Federal Reserve is expected to cut the fed funds rate by 0.25% when the Federal Open Market Committee (FOMC) meets next Tuesday and Wednesday (July 30-31), a move that Chairman Jerome Powell and other officials have recently signaled. According to the federal funds futures market, there is a 100% certainty that the rate will be lowered next week, with a 76.5% probability of a quarter-point drop and a 23.5% likelihood of a half-point decrease.

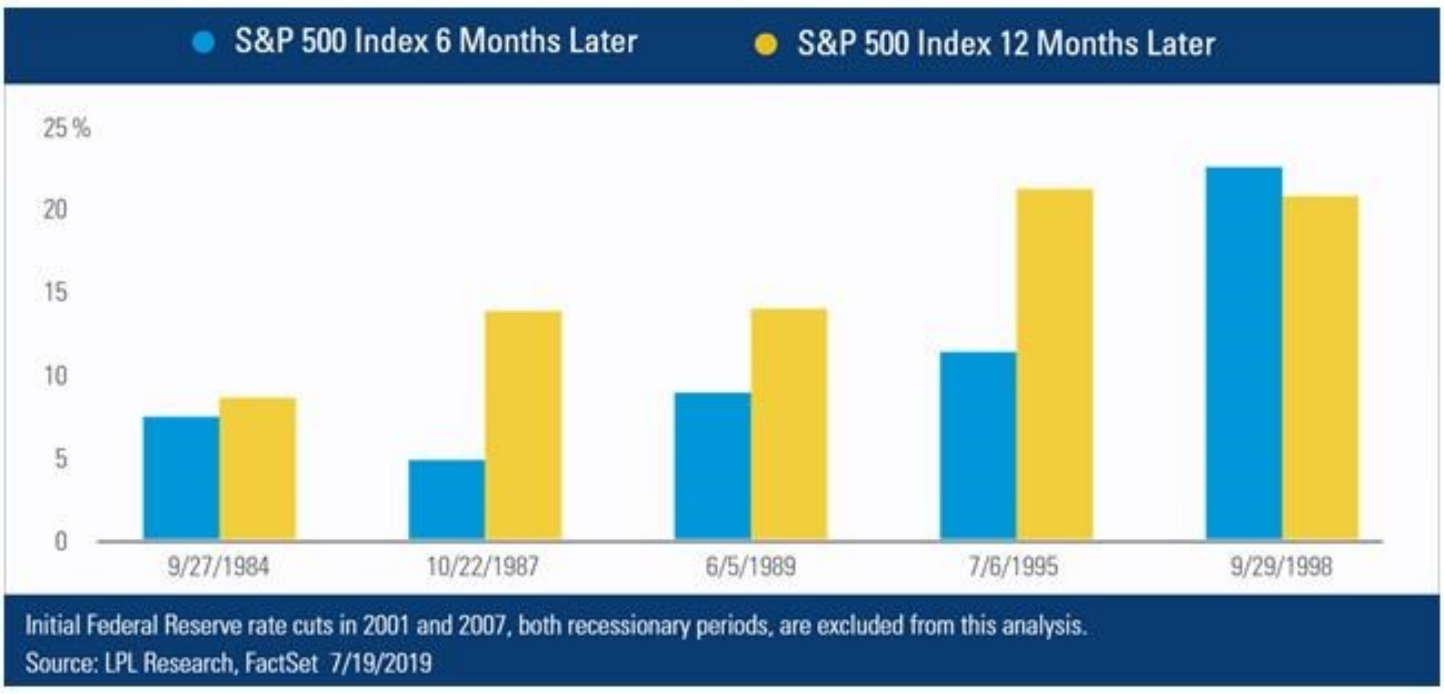
If the Federal Reserve reduces the fed funds rate, it will mark the first time that the overnight borrowing rate between banks and other depository institutions will have been lowered since December 2008. It was effectively zero at that point. As shown in the chart above, the Fed subsequently raised the target rate by 0.25% nine times between December 2015 and December 2018 to the current level of 2.50%. The last four increases all occurred last year with the final hike clearly a mistake in the face of rapidly falling yields on 2-year and 10-year U.S. Treasury Notes.

Accordingly, we believe that a rate cut will be viewed as taking back the ill-advised hike in December and contend that an additional cut or two may be in the offing before the end of the year with the goal of getting the fed funds rate more in-line with Treasury yields. An easier monetary stance is in order due to the fact that inflation remains under the Fed's 2% target, and it should also help offset the slowdown in global growth and uncertainty surrounding trade policy.

As displayed below, the last five times the Fed began reducing rates outside of recessions (1984, 1987, 1989, 1995, and 1998), the S&P 500 advanced an average of 11.1% over the subsequent six months and 15.8% over the next year (with positive results in every case). The market did *not* perform well after the initial rate cuts in 2001 and 2007 when the economy, in both cases, was in the midst of recession. Therefore, all bets are off if the economy is already in recession, a condition we highly doubt.

With a rate cut all but assured next week, investors will be focused on the "dot plot," a chart that records each official's forecast for the central bank's key short-term interest rate, as well as language in the Fed statement and press conference to gauge the direction and magnitude of future changes in monetary policy. The risk in lowering rates too aggressively is in overstimulating all-time high asset prices unnecessarily. Consequently, the Fed needs to be mindful of the effects of doing too little or too much. We're hopeful that Chairman Powell & Co. can strike a balance between the two sides.

Stocks Tend to Rise After Initial Rate Cuts Outside of Recessions



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