

# Investment Note



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## The Fed cuts, but does it do anything for earnings?

Without much surprise to the market the US Federal Reserve implemented its first interest rate cut since December 2008. The Federal Open Market Committee (FOMC) announced a 25 basis point rate cut to bring its target rate to 2.0% - 2.25%. The cut of 25 bps was widely expected by the market as the narrative from Fed officials over the past year has shifted from the potential for continued tightening, to a pause in further rate hikes, to the current easing bias.

This has been a very well-orchestrated cut with Fed officials speaking in favour to support an extension of the current economic expansion, including New York Fed President Williams and Chicago Fed President Evans.

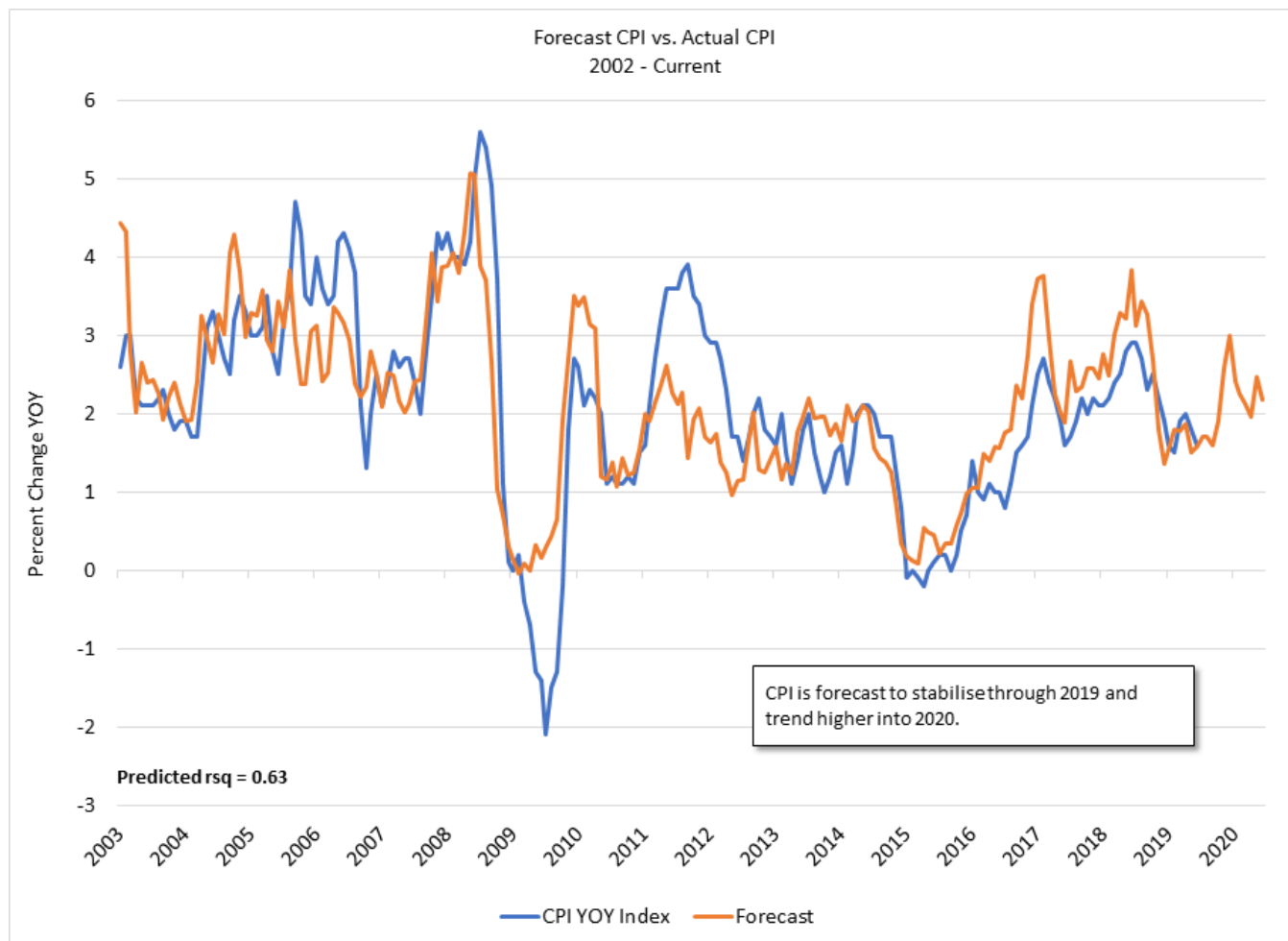
We do not believe the decision to cut the Federal Funds Rate by 25 bps came easy given the current economic environment in the United States. Recent economic data has seen the US economy grow through the first and second quarters at an annualized rate of 3.1% and 2.1% respectively, unemployment has fallen from 4% in January to its current 3.7% and the 4-week moving average for jobless claims remains near the lows of the last year. In fact, we read the statement as less dovish than perhaps the market wanted.

In its statement the FOMC commented “Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. In light of the **implications of global developments for the economic outlook** as well as muted inflation pressures, the Committee decided to lower the target range for the federal funds rate to 2 to 2-1/4 percent.” (emphasis ours)

Although the cut was widely expected, the reasons are varied. Some are calling this an “insurance cut”, while others believe it is the start of a new easing cycle. Then there are those that are in the “reflation” camp.

Inflation or price stability, one mandate of the Fed's two (in addition to full employment) has remained below the target of 2% - as measured by the Fed's preferred gage of inflation, the Personal Consumption Expenditures Index. New York Fed President John Williams said that recent research has shown that policy makers need to "vaccinate the economy and protect it from the more insidious disease of too low inflation."

The Fed may not need to wait long on a potential reflation as our inflation model suggests a modest increase in inflation into 2020. While our model is focused on the Consumer Price Index, we believe the trend of modestly higher inflation will translate to the PCE Index.



Source: Manulife Investment Management, Bloomberg as of June 30, 2019

In this regard the cut is being treated dually as a "reflation" measure to help boost inflation and as well, will also serve as an "insurance cut" to support the economic expansion amidst a slowing global economy hampered by geopolitical risks (Iran) and trade tensions (US/China and Japan/South Korea to name two). Fed chairman Jerome Powell alluded to the global environment in a speech in Paris two weeks ago, "Pursuing our domestic mandates in this new world requires that we understand the anticipated effects of [global] interconnections and incorporate them into our policy decision-making," he said.

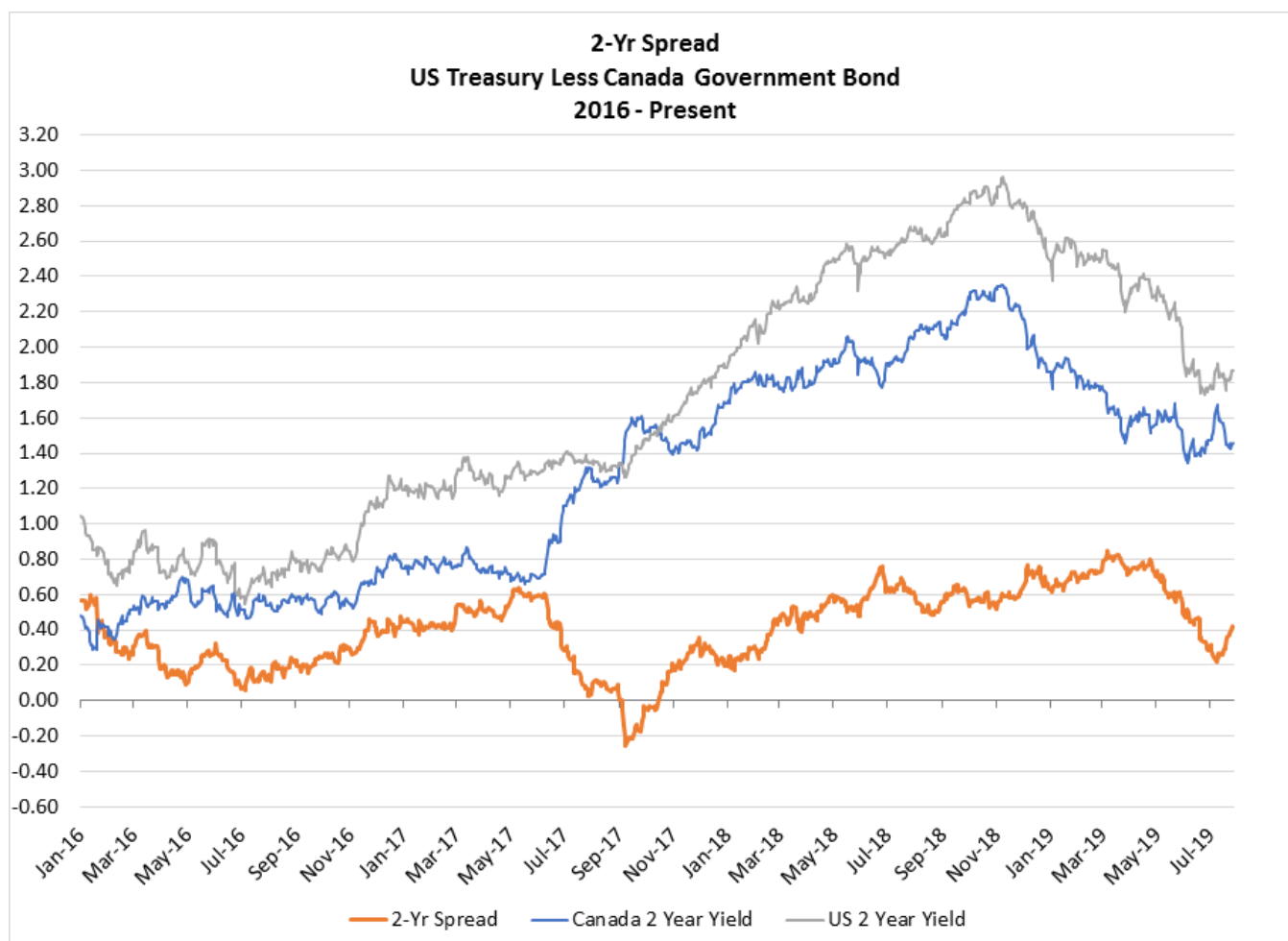
Should inflation follow our model and trade tensions subside, this would justify a very short and brief tightening cycle by the FOMC. In this scenario, while it is not our base case, we cannot rule out that the Fed may be "one and done."

From the investment implications, given this cut has been the worst kept secret of Fed moves, and joins the many other central banks that have cut interest rates this year, we need to look forward to what follows and what, truly, this cut means as a statement towards the risks in the US economy through the remainder of 2019 and into 2020.

For Canadians, the expectation of a rate cut by the Fed has driven the loonie higher in recent months as bond markets started pricing in the probability of a 25 – 50 bps rate cut by the FOMC against a Bank of Canada that was likely to stay on the sidelines for the time being. The difference between the Canadian two-year yield and US two-year yield narrowed from a high of 80 bps near the end of April to 22 bps at the beginning of July. That spread narrowing put upside pressure on the CADUSD exchange rate, driving the loonie up to a high of US\$0.7675.

As the FOMC meeting approached, the potential for a 50 bps cut decreased and the likelihood of a 25 bps cut solidified. This resulted in a widening of the 2-year yield differential back slightly above 40 bps, reversing the direction for the CADUSD exchange rate, dropping below \$0.76

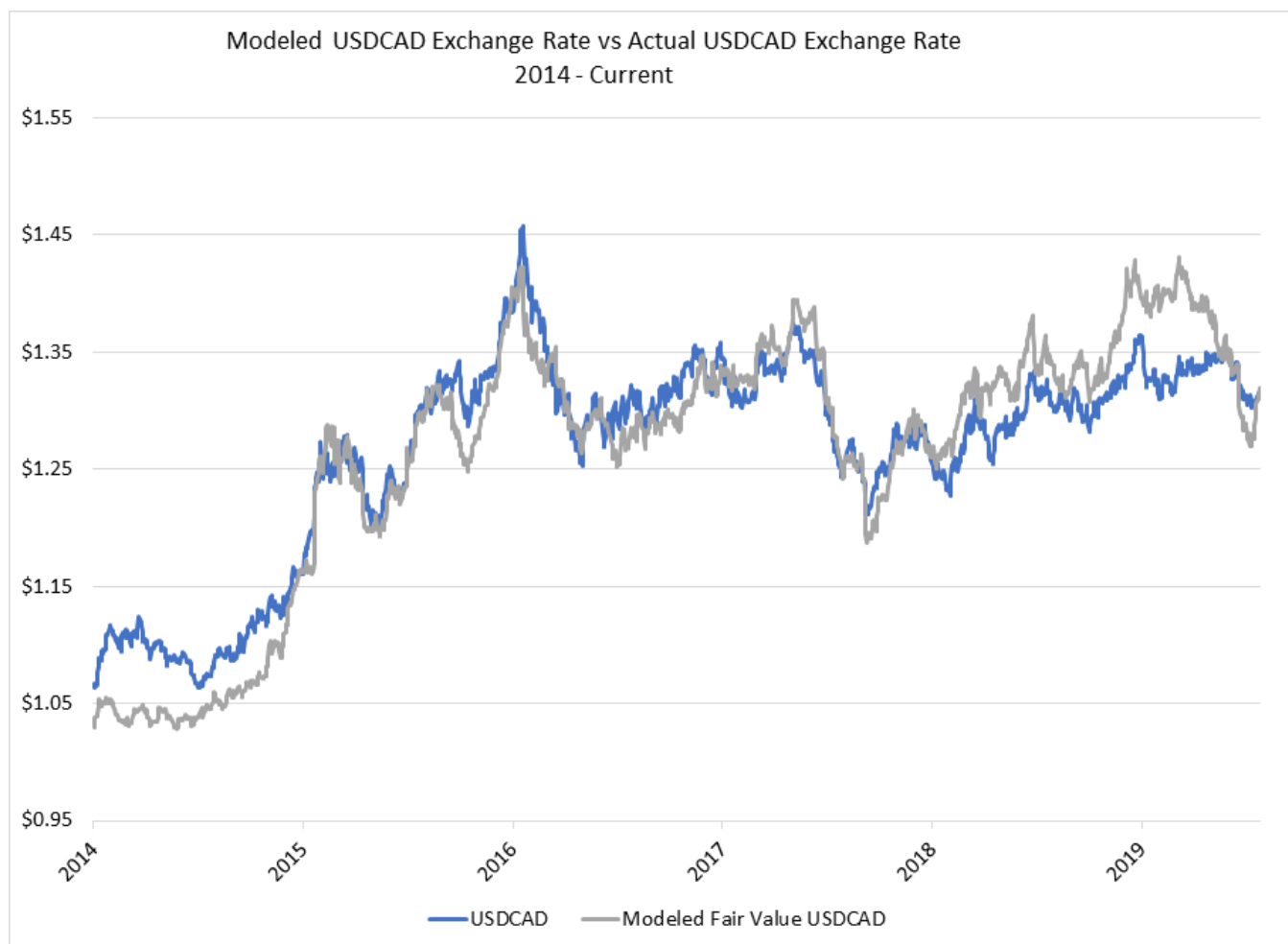
If we add in the additional impact of oil prices, our team's fair value model indicates a \$0.758 loonie, or just about exactly where it is trading today. The correlation between the CAD/Oil/Rates had swung in favour of rates. The correlation oscillates between oil and rates fairly quickly. However, through the remainder of the year we believe rates and oil will have a similar influence, i.e. driving the CADUSD lower toward US\$0.74.



Source: Manulife Investment Management, Bloomberg as of July 26, 2019

We believe the recent widening of the spread reflects the uncertainty and mixed messages surrounding the Canadian economy and rate path for the Bank of Canada. The probability that the BoC will follow the Fed cuts with a cut of their own in October is increasing but has yet to be priced into the bond market. Given expectations of an additional cut by the Fed and at least 1 cut by the BoC we would expect the spread to widen out further between now and October. Factoring for a 50 bps spread by October the fair value for the CAD would be US\$0.7467 with risk to the downside on weakening crude prices.

With respect to the bond markets, we believe investors have priced in an additional 50 bps in cuts by the Fed. Our base case is for one additional cut by the FOMC that will push US yields modestly higher than today's levels. We don't believe we will see a repeat of the rising yield environment of the back half of 2018.

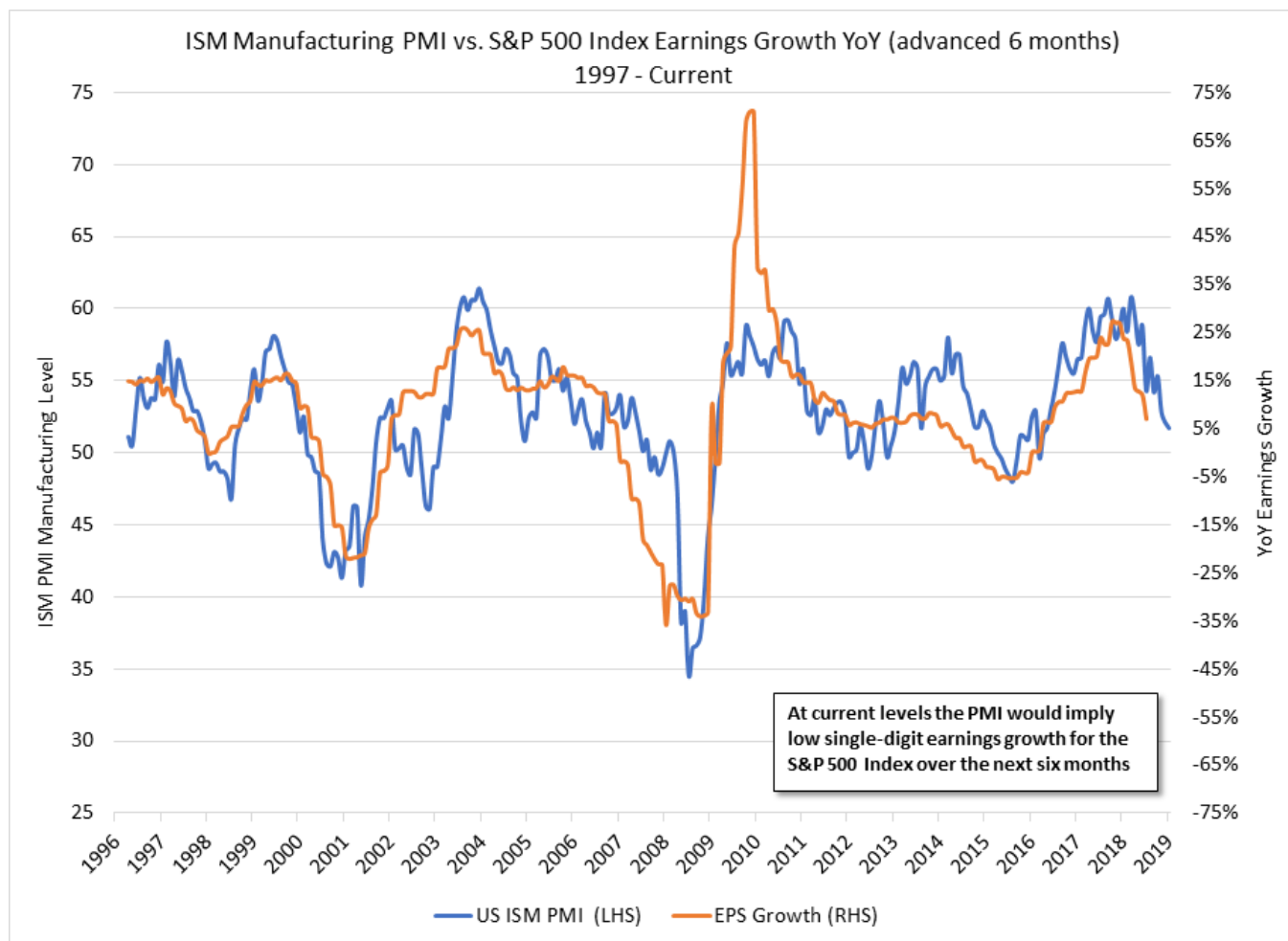


Source: Manulife Investment Management, Bloomberg as of July 26, 2019

Historically, US equity markets have tended to rally following a rate cut, but that has often been because the Federal Reserve is starting on an easing cycle during a recession. We don't believe this to be the case today. While we see evidence of a global economic slowdown, we struggle to see evidence of the greater risk of a recession, at least for the time being. Additionally, as this cut was well telegraphed, we would argue equity investors have already priced it (and perhaps one more) in.

While the equity market may rally on the back of this more accommodative central bank move, our team does not believe that it is a buying signal. A rate cut may help short-term market sentiment, and may support the “reflation” trade, it does not solve the problem facing equity investors at hand – trade tensions and lackluster earnings growth.

Global trade, manufacturing, and inventories have all weakened since the beginning of 2018. Manufacturing, as measured by the Purchasing Managers Indices (PMIs) have been impacted by trade tensions. The US Institute for Supply Management PMI has been a solid indicator for future earnings growth for the S&P 500 Index. At current levels, it indicates mid-single digit earnings growth at best over the next two quarters on a year-over-year basis with risk to the downside.



Source: Manulife Investment Management, Bloomberg as of July 26, 2019

Equity returns are a function of earnings and valuation. Any market rally is likely to be by way of an expansion in Price/Earnings Ratio multiple rather than improved outlook for earnings growth. Without substantial proof that fundamentals have bottomed and are starting to turn positive – which we don't believe we have - we believe it would be prudent to reduce risk and fade any rally should equities grind higher until the evidence suggests otherwise.

Overall, we would argue that markets got some of what they wanted but the Fed still left them wanting more. The FOMC followed through with a 25 bps rate cut and language consistent with their recent tone of apprehension towards the global economy. However, we are hard pressed to suggest that the Fed is committed to further or more aggressive cuts barring greater economic weakness. We believe the environment remains lackluster for earnings (globally) and therefore for equity market performance (also somewhat globally) over the coming 6 – 12 months. For the time being, we may be back to a triple-B environment – Bumpy, Boring, and Below-Average.

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