CIO Memo

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Fed stays the course, but warns of a bumpy-road to recovery

Key take aways

- The Federal Reserve continues to hold their policy rate, while also offering dovish forward guidance to help sustain the rebound in economic activity.
- U.S. Equities, Gold and Treasury prices gain ground as the U.S. Dollar index continues to descend.
- We anticipate that the Fed will remain supportive, utilizing their broad set of tools at their disposal as we enter the more vulnerable phases of the economic recovery.

1. What happened?

Federal Reserve officials decided to make no changes to their target benchmark rate, leaving it at same 0.00-0.25% range set back in March. Additionally, the committee members also left the schedule and size of the existing bond buying program (with minimum purchases of $80B in Treasuries and $40B in MBS per month), along with their Interest on Excess Reserves (IOER) rate, unchanged. Perhaps, the only notable update today was centered on their lending facilities that are used to support dollar-repo and swap lines, which has so far proven to be successful in providing liquidity and maintaining healthy financial conditions throughout the crisis. With the current deadline set to expire in September, the FOMC has now extended this program's life through at least the end of March. This move was widely anticipated since committee members have individually shown support in extending this program in recent interviews.

The Fed Statement was mostly left unchanged and remained dovish. First off, the central bank noted that the economy has seen improvements in certain areas, such as the labor market. However, the sharp decline in aggregate demand has moved inflation further away from the Fed's stated goals. Secondly, and perhaps more importantly, the Fed left their forward guidance language in the statement unchanged, signaling unwavering support to help foster this economic recovery.

2. How did markets react?

U.S. equities finished the trading session higher and near their best levels with the S&P 500 rising over 1.24% to 3,258. Performance was broad based with the Energy (+2.13%) and Financial (+2.02%) sectors leading the group. Gold continued its impressive streak in price performance, rising 0.77% to $1,960 per ounce, while the DXY index fell 0.33% to 93.38. Treasuries bonds rose as both 2-year and 10-year yields fell slightly on the day.

3. What does it mean for investors?

Known expectations for July's meeting justified the market's relatively muted reaction. It is likely that the Fed might be preparing for further changes in their next meeting (in September). This should allow the committee more time to build any consensus needed amongst its voting members to help navigate the tougher decisions surrounding what to do next with its balance sheet, open market operations, or even some other "non-traditional" measures. Meanwhile, headlines are likely to shift to the fiscal side. Currently, we still are lacking the details of a final comprehensive deal, but we should expect that the next stimulus package is likely to be a disappointment in both size and scope. Ultimately, this more 'poultry sized' fiscal package may likely lead the FOMC to possibly consider QE measures that are both more targeted, or even possibly linked back to the interest rate yield curve.

Therefore, we would advise clients that Fed is most likely to continue to keep their benchmark policy rate unchanged through at least the next 12-months. After all, the U.S. economy is still facing immense uncertainty surrounding its recovery now that virus cases have resurged. Furthermore, investors should prudently prepare for additional bouts of volatility as the pace of the recovery begins to moderate off the strong bounce seen from the initial re-openings.

Lastly, tomorrow's Q'2 GDP report may possibly mark the end of the COVID-19 recession. Economist's consensus estimates anticipate that U.S. economy should contract by approx. 35%. However, we should be prepared for substantial surprises to the negative or positive side, as we know that accurate forecasting in these unprecedented times is surely difficult. Regardless of the scale of the second quarter downturn, the recent resurgence in cases is already making a negative impact on the consumer's psyche and high frequency indicators, leaving the next phase of this recover on a vulnerable path.

Glossary

An overnight index swap (OIS) is an interest rate swap where the periodic floating payment is generally based on a return calculated from a daily compound interest investment.

A mortgage-backed security (MBS) is a type of asset backed security which is secured by a mortgage or collection of mortgages.

Libor or London Inter-bank Offered Rate is an interest-rate average calculated from estimates submitted by the leading banks in London.

GDP or Gross domestic products is a monetary measure of the market value of all the final goods and services produced in a specific time period, often annually.

Purchasing manager indices (PMI) provide an indicator of the economic health of the manufacturing sector and are based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment. The composite PMI includes both manufacturing and services sectors. They can be published by public sector or private agencies (e.g. Caixin, Nikkei).

SAAR or Seasonally adjusted annual rate is a rate that is adjusted to take into account typical seasonal fluctuations in data and is expressed as an annual total.

The S&P 500 is a stock market index that measures the stock performance of 500 large companies listed on stock exchanges in the United States.

The Fed and Federal Reserve System is the central banking system of the United States of America.

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