
# Mid-year 2019 fixed income survey: Who'll act first – the Fed or markets?

*By Adam Smears*

Throughout the year we ask bond and currency managers to consider valuations, expectations and outlooks for the coming months.

Our Q1 2019 outlook survey showed a clear shift in sentiment, with the U.S. Federal Reserve (the Fed) adopting a more dovish stance on the back of moderating economic data. Bearish managers in 2018 turned increasingly bullish on interest rates and the U.S. dollar in 2019 – once again seeing differing views from interest-rate and credit managers. However, as we have seen, the government bond market ended up pricing in an even weaker economy than what the survey implied.

In this mid-year survey, interest rate and credit manager views have continued to come at odds with one another, with the backdrop of slowing U.S. growth over the past few months. That is why in this survey report, we ask: ***Who'll respond to slowing U.S. growth first – the Fed or markets?***

## Today, we put the spotlight on:

- Slowing U.S. growth
- Risk assets across the globe

In May, we received answers from 62 investment managers from across the world.

## Who'll respond to slowing U.S. growth first – the Fed or markets?

### *Views from interest rate managers*

- Overall, interest rate managers are clearly concerned about financial conditions and global growth, hence the shift in the interest rate expectations.
- Managers are betting that the Fed will react to slower growth by ending rate hikes (possibly even cutting) and that easier Fed policy will support risk assets.
- Since the conclusion of our survey, market pricing has taken it a step further by betting that the Fed will cut rates twice by year end.

### *Views from credit managers*

- For now, managers remain optimistic in their view of risk assets even though the information from interest rates continues to portray a challenging growth environment – indeed the inverted yield curve would suggest as much.

- Given credit managers are comfortable with the 12-month outlook for credit, it suggests that they believe the Fed can orchestrate a smooth path through the control of interest rates.

## Who'll act first?

Will the Fed act first and cut rates as early as the July FOMC meeting (which the market has priced as an 80% chance as of June 17, 2019), or will the Fed play a wait-and-see approach, possibly disappointing risk markets and leading to a sharper sell-off in equities and credit spreads? Would such a sell-off tighten financial conditions enough to then force the Fed to act?

Uncertain trade developments (notably with China), alongside moderating economic data, may more likely than not lead the Fed to cut rates potentially at its July meeting – with possibly a second cut in September.

## Risk across the globe

### *Europe and UK*

- European managers are less optimistic on Europe. In credit, Europe had previously been more popular, but the U.S. is now taking that lead in both corporate high-yield and investment-grade credit.
- G30 foreign-exchange (FX) managers have also weakened their view on the euro.
- Despite political changes in the UK and risks of a hard Brexit, the base-case view from G30 FX managers is that the UK sterling will brush off headwinds and appreciate from current levels.

### *Emerging markets and Japan*

- For local and hard emerging-market currency managers, Argentina and Brazil are the favourite areas to increase risk.
- G30 FX managers also prefer the Japanese Yen as either a value or risk-averse position.

## Conclusion

In this survey, we have seen that interest rate managers expect the Fed to react to slower U.S. growth by ending rate hikes (or even cut rates) to support risk assets. This was further supported by Fed commentary highlighting that recent trade concerns (in combination with economic data) has put them in a position to "act as appropriate to sustain the expansion." Meanwhile, credit managers are not overly concerned by the threat of a recession or deterioration in risk assets over the next 12 months.

The views of interest rate managers and credit managers continue to be at odds, leaving two remaining questions: Will interest rate managers accurately predict a substantial slowdown in global growth? Or will credit managers prevail through their confidence in the Fed put? If credit managers prevail, it would indicate that any evidence of a slowdown will be effectively managed through the Fed's toolkit, ultimately supporting the performance of risk assets.

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