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THE FED'S U-TURN: OVERTIGHTENING DOWN THE ROAD?

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INTRODUCTION

On 31 January, the Federal Reserve discarded a promise to keep raising rates, and instead pledged "patience" on further policy change and signaled flexibility in reducing its bond holdings.

Immediately after the statement was published, we were worried that the Fed could have decided to be structurally behind the curve to help monetize the larger US fiscal deficits. Such a scenario would imply that default rates would continue to be structurally suppressed, and thus support a strategy of owning the highest yielding/lowest quality assets possible.

However, in the Q&A, Fed Chairman Jerome Powell clearly stated that the unsustainability of the fiscal deficit was a long-term problem that exceeded the Fed's horizon. This, in our view, is a clear indication that the Fed is not considering deficit monetization and that Fed policy is only focusing on the inflation and employment mandate.

REASONS FOR THE CHANGE OF TONE

At this point, we do not believe that the US activity data – particularly since the shutdown has ended and a large part of the activity lost during that period should be recovered – justifies an end of the US tightening cycle or tapering of quantitative tightening ('QT') in coming meetings.

We still think that the increase in the net supply of high quality government bonds will crowd out demand for substitute assets, emerging-market debt ('EMD') included, due to:

- A larger US fiscal deficit;
- QT in the US (we had expected it to end in the third quarter of 2020 at roughly USD3 trillion, or three times larger than what it was prior to quantitative easing);
- The end of QE in Europe;
- The reduction in bond buying by Bank of Japan.

We have three hypotheses as to why the Fed may have changed its tone in the last six weeks by so much more than what the economic data would suggest:

- There is something very bad happening, or that could happen, that market participants are not aware yet, which requires that the Fed's give itself the flexibility to cut rates or end the tightening sooner than it had anticipated. Such an event, unless it is something that will affect mainly the US and not the rest of the world, could hardly be good for EM assets;
- The ongoing trade negotiations with China: A more dovish Fed stance (where the Fed pauses from further tightening) and the US government shutdown ending (and hence the economy recovering) makes the US's threats of increasing tariffs more credible. Currently, the market consensus is that the negotiations will be extended without more tariffs, which is a scenario that would suit China's strategy of buying more time;
- The Fed panicked on the back of December's equity and spread volatility. It is trying to ensure that unless it sees inflation, it will not overtighten.

We think that the third option is the more likely to be behind the Fed rationale. Powell has stated that he needs to see inflation above the target. Thus, by the time core inflation is above 2% (currently it is at 1.9%) for two or three months of such readings, the Fed would be massively behind the curve. As such, the tightening – that would be required to bring it back to target – would be larger and could end up triggering the next global recession.

With credit spreads (for the credits unlikely to default) at levels not far from the tights of the post-global financial crisis period, and currencies not cheap enough to support better current account balances on average for the EM universe (even though they may look cheap on a standalone basis), it is difficult to foresee losing much money over a 1-year horizon with a defensive portfolio and a carry of close to 5% p.a. On the other hand, in any of the hypotheses above, risk assets, EMD included, are likely to suffer.

CONCLUSION

We would hope that the more dovish tone was adopted for the second reason argued above. However, we unfortunately believe that it was due to the third one. Either one would imply, in our view, that the Fed has ceased to be independent and increases the chances that it will need to overtighten down the road.

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