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Searching for neutral

Rate cut shows Fed still unsure of the right policy level

Published 08-01-2019

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Neutral is not a position much in favor these days, but Federal Reserve policymakers would love to get the federal funds rate there. They have targeted 2% for some time now, but lately aren't sure that is the correct level. At one point they talked about it being somewhere within a range of 2.75-3%, then somewhere in a much lower span of 2-2.25%. With inflation measured by personal consumption expenditures stubbornly refusing to get to 2%, even the latter range might be too high.

That search is at the heart of the members of the Federal Open Market Committee's decision to cut the target range of the fed funds rate by a quarter point yesterday. They have made clear this is not the beginning of a path leading to zero rates as we experienced following the financial crisis, but rather a pullback from December's hike that shot too high. There were no projections from this meeting, but Chair Jerome Powell suggested that another move may or may not be warranted, and the futures market is expecting at least one more. The hunt continues.

Actually, that search is not the only one involving the Fed these days. It still needs to fill its open seats. At the beginning of July, President Trump nominated two candidates for spots on its board. Trump has, of course, berated the Fed (specifically targeting Powell) for raising rates. He now seems to be taking a direct approach by nominating candidates who fit his current desire for interest range decreases. But, unlike some of Trump's other candidates who didn't even come to a vote, these would seem to have a better chance of being confirmed.

Director of research at the St. Louis Fed, Christopher Waller has strong credentials. It's no surprise he would advocate for dovish policy as he comes from the Bullard camp. James Bullard, president of this branch, was the only one in the June meeting who dissented, wanting a cut. I was at the St. Louis Fed in July and spent time with Bullard, as well as Raphael Bostic from the Atlanta Fed. They reiterated that they are focused on finding neutral, not returning to 2008-2015. Economist Judy Shelton, U.S. envoy to the European Bank for Reconstruction and Development until she resigned last week due to the nomination, also is a credible contender.

There's also a search for a replacement for the London interbank offered rate (Libor), which will eventually be dethroned as the main reference for floating-rate securities. That's still far away, but the leading contender remains the New York Fed's Secured Overnight Financing Rate (Sofr). As of now, Sofr is not ready for prime time. Progress is being made, but the lion's share of issuance has come from government agencies. Fannie Mae and Freddie Mac have been good about offering Sofr-based floating-rate securities that are eligible for money market funds. But to convince the financial industry, the index needs to have a credit component and a curve.

Participants in the liquidity marketplace found an ample supply of securities in July, particularly in the repo market and in the Treasury market. There also were fewer buyers in the marketplace and money market funds—not Federated—lost assets. Combine all of these and repo rates hung in there at elevated levels throughout the month. We did not adjust our weighted average maturity (WAM) ranges in July, still 30-40 days for our government funds and 40-50 days for prime and municipal funds. On a fixed-rate basis, we are sticking with the 3- and 4-month areas, not going too far out beyond that. The Treasury curve ended July with 1-month at 1.995%, 3-month at 2.069%, 6-month at 2.079% and 12-month at 2.010%. Libor ended the month with 1-month at 2.22975%, 3-month at 2.25313%, 6-month at 2.19163% and 12-month at 2.18850%.

TAGS

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Views are as of the date above and are subject to change based on market conditions and other factors. These views should not be construed as a recommendation for any specific security or sector.

London interbank offered rate (Libor): The rate at which banks can borrow funds from other banks in the London interbank market. The Libor is fixed on a daily basis by the British Bankers' Association and acts as a benchmark for other short-term interest rates.

Secured Overnight Financing Rate (SOFR): a broad measure of the cost of borrowing cash that is collateralized by U.S. Treasury securities. The New York Fed publishes SOFR on a daily basis.

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