The Fed in 2020

Key takeaways

» We believe that the Federal Reserve (Fed) will remain patient (relative to additional stimulus) in 2020, but it should be ready to sustain the economy if needed. We expect the Fed to be proactive in adding liquidity to help ensure reserves remain ample and to help reduce the risks of money market pressures.

» In our view, there is little chance of inflation threatening higher U.S. interest rates in 2020; therefore, we believe that the Fed will attempt to incorporate average inflation targeting as an enhancement to its current policy.

What it may mean for investors

» We believe the Fed’s proactive stance as the economy slows should put some additional downward pressure on intermediate and long-term interest rates. In turn, we expect low rates to support equity valuations and single-digit U.S. equity returns in 2020.

Many central banks around the world remained supportive of their economies throughout 2019. We believe that this trend will continue in 2020 in an effort to stave off the global economic slowdown.

As the Fed continues to work to sustain the U.S. recovery, we believe that there are three major themes that will influence the Fed in 2020.

1) Coordinated interest-rate policy and balance sheet management

So far, the Fed has signaled that it likely will pause from cutting rates as we move toward 2020 after the three rate cuts it implemented this year. Fed voting members want to observe how the U.S. economy continues to evolve, since the effects of rate cuts are usually delayed. Fed members also want to monitor external risks caused by the global slowdown and the U.S-China trade dispute. Our current stance is that the Fed will attempt to remain on hold, but if trade negotiations deteriorate or the U.S. economy begins to slow more than expected, there could be additional rate cuts in the first half of 2020.

We expect the Fed to continue expanding its balance sheet in 2020 to accommodate the increased desire of primary dealers and banks to hold more bank reserves. Additionally, we believe the Fed should continue to conduct term and overnight repurchase agreement operations through the first half of next year to help ensure that the supply of reserves remains ample and to help mitigate the risk of money market pressures.
Chart 1 illustrates how Reserve bank credit already has increased as the Fed has continued to add short- and long-term Treasury securities to its balance sheet while allowing mortgage-backed securities to roll off. According to the latest Federal Open Market Committee (FOMC) meeting minutes, FOMC members appear to be more interested to implementing a standing repurchase-agreement facility. We believe that this will allow dealers and banks to access reserves on an as-needed basis and help to maintain the fed funds rate target within the target range.

**Chart 1. The Fed should continue adding liquidity but won’t call it QE**


2) Sharing findings from the Fed listens events

The Fed announced in November 2018 that it would conduct a broad review of the strategy, tools, and communication practices it uses to pursue its monetary policy goals. After the series of Fed events that took place throughout 2019, it is expected that policymakers will report their findings to the public during the first half of 2020.

We expect the Fed to share more details about the three main topics the Fed has been discussing: lower interest rates for longer; average inflation targeting; and directed bond purchases in an effort to target specific yields on specific securities (also referred to as yield curve control). Inflation targeting will most likely take center stage in 2020—not only because the Fed has struggled to reach its inflation target—but also because there appears to be little chance of inflation threatening higher U.S. interest rates, particularly with the expectation of lower U.S. gross domestic product (GDP) growth next year. If a recession begins to draw near in 2021, and lowering short-term interest rates to zero isn’t enough to stimulate the economy, we believe that the Fed will consider implementing yield curve control; however, we realize that we are likely still far away from this.
3) Focus on growth and addressing potential vulnerabilities to the outlook

Weaker economic growth is expected in 2020 in many major economies around the world. In our view, this poses a greater threat than low inflation. The Fed will probably give the economy plenty of opportunity to overheat. The Fed expects household spending to remain on a firm footing, supported by strong labor market conditions, rising incomes, and favorable financial conditions. In addition, the Fed believes household spending that is more sensitive to interest rates, such as consumer durables, is expected to increase, as the effects of lower interest rates begin to manifest positively in 2020.

Still, there are external factors—such as stresses in Europe related to Brexit and developments in emerging markets—that have the potential to adversely affect the current outlook. Furthermore, the Fed is paying particular attention to liquidity risks in the U.S. financial system, along with potential stress that could stem from overextended businesses with high leverage.

If needed, we expect the Fed to be more proactive in the first half of the year, but to be on hold as the election period draws near. Despite continued comments from the president, the Fed has focused clearly on its dual mandate in 2019; it has remained neutral toward politics. The Fed’s proactive stance while the economy slows should put some additional downward pressure on intermediate and long-term U.S. interest rates. In turn, we expect low rates to support equity valuations and single-digit U.S. equity returns in 2020.
Risk Considerations

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve.

Equity securities are subject to market risk which means their value may fluctuate in response to general economic and market conditions and the perception of individual issuers. Investments in equity securities are generally more volatile than other types of securities.

Investments in fixed-income securities are subject to interest rate, credit/default, liquidity, inflation and other risks. Bond prices fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can result in the decline in the bond’s price. Credit risk is the risk that an issuer will default on payments of interest and principal. This risk is higher when investing in high yield bonds, also known as junk bonds, which have lower ratings and are subject to greater volatility. If sold prior to maturity, fixed income securities are subject to market risk. All fixed income investments may be worth less than their original cost upon redemption or maturity.

Although Treasuries are considered free from credit risk they are subject to other types of risks. These risks include interest rate risk, which may cause the underlying value of the bond to fluctuate.

In addition to the risks associated with investment in debt securities, mortgage-backed securities will be subject to prepayment, extension and call risks. Changes in prepayments may significantly affect yield, average life and expected maturity. Extension risk is the risk that rising interest rates will slow the rate at which mortgages are prepaid. Call risk is the risk that if called prior to maturity, similar yielding investments may not be available for the Fund to purchase. These risks may be heightened for longer maturity and duration securities.

Investing in foreign securities presents certain risks not associated with domestic investments, such as currency fluctuation, political and economic instability, and different accounting standards. This may result in greater share price volatility. These risks are heightened in emerging markets.

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