Baird Market and Investment Strategy

Macro Update

June 4, 2019

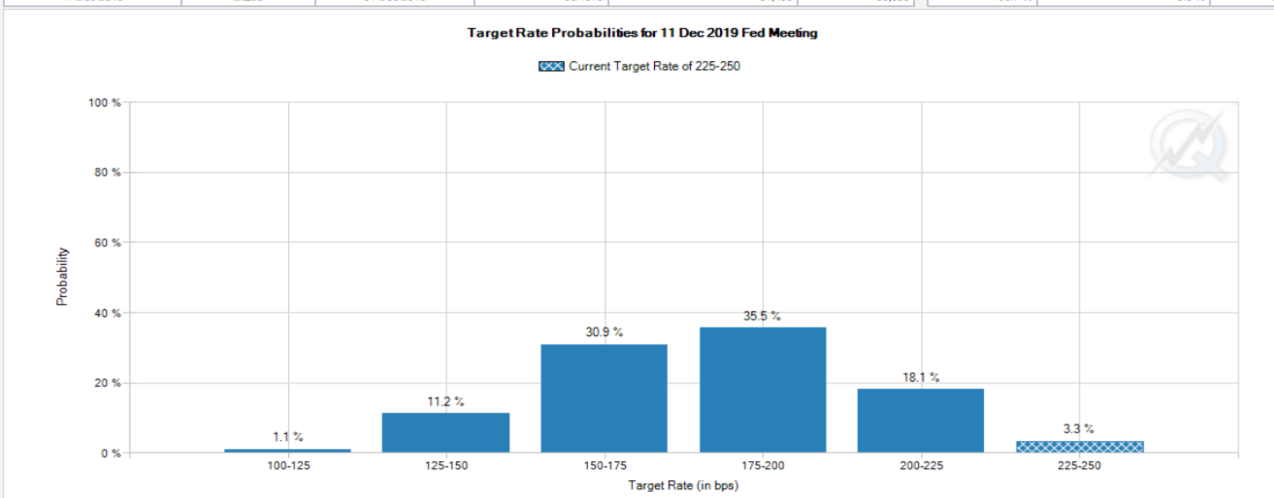
Please refer to Appendix – Important Disclosures.

Rate Cut Expectations Getting Ahead of Fed Intentions

Key Takeaways: Interest rate cut expectations have soared over the past month and Treasury yields have moved to their lowest levels since 2017. Inflation continues to drift higher. Absent a significant drop in business confidence, moderating economic activity is likely to represent cyclical slowing rather than a precursor to recession.

Rising trading tensions and other evidence of global economic uncertainty has led to a notable uptick in expectations that the Federal Reserve is going to be cutting interest rates sooner rather than later. Data from the CME group shows a 97% chance of a rate cut by the end of 2019, with the probability distribution showing a better than 1 in 3 chance of 50 basis points of easing between now and then. Individual economists have joined this chorus as well, with some looking for "insurance cuts" beginning as early as July. For perspective, a month ago there was a better than even chance of no cuts in 2019. At this point, the Fed appears to be playing a game of chicken with both the fed funds futures market and President Trump. At least some on the Fed have expressed reluctance to be handcuffed by market expectations and there may be hesitancy to lower rates as a result of a reversible, self-inflicted economic wound (higher tariffs). Our view is that despite the reaction in the bond market, neither incoming inflation nor activity data support rate cuts at this point.

MEETING INFORMATION						PROBABILITIES		
MEETING DATE	CONTRACT	EXPIRES	MID PRICE	PRIOR VOLUME	PRIOR OI	EASE	NO CHANGE	HIKE
11 Dec 2019	ZQZ9	31 Dec 2019	98.1575	31,406	85,650	96.7 %	3.3 %	0.0 %



TARGET RATE (BPS)	PROBABILITY(%)			
	NOW *	1 DAY 3 JUN 2019	1 WEEK 28 MAY 2019	1 MONTH 3 MAY 2019
100-125	1.1%	2.8%	0.0%	0.0%
125-150	11.2%	16.7%	1.0%	0.1%
150-175	30.9%	34.1%	8.5%	1.1%
175-200	35.5%	31.4%	28.5%	9.3%
200-225	18.1%	13.0%	41.0%	36.9%
225-250 (Current)	3.3%	1.9%	20.9%	52.7%

* Data as of 4 Jun 2019 11:29:11 CT

Source: CME Group

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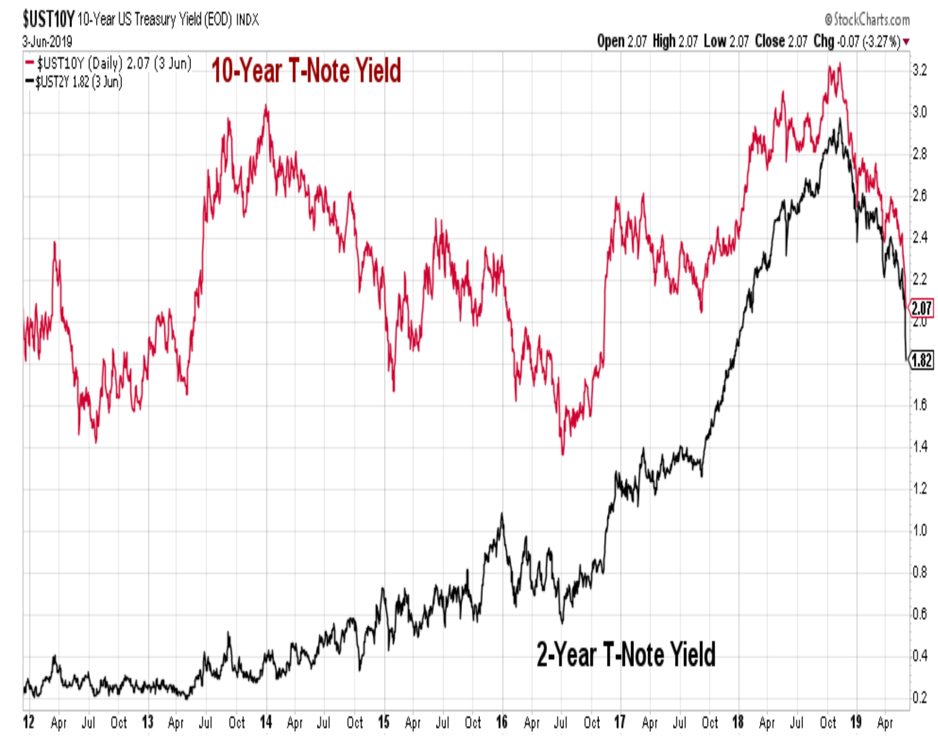
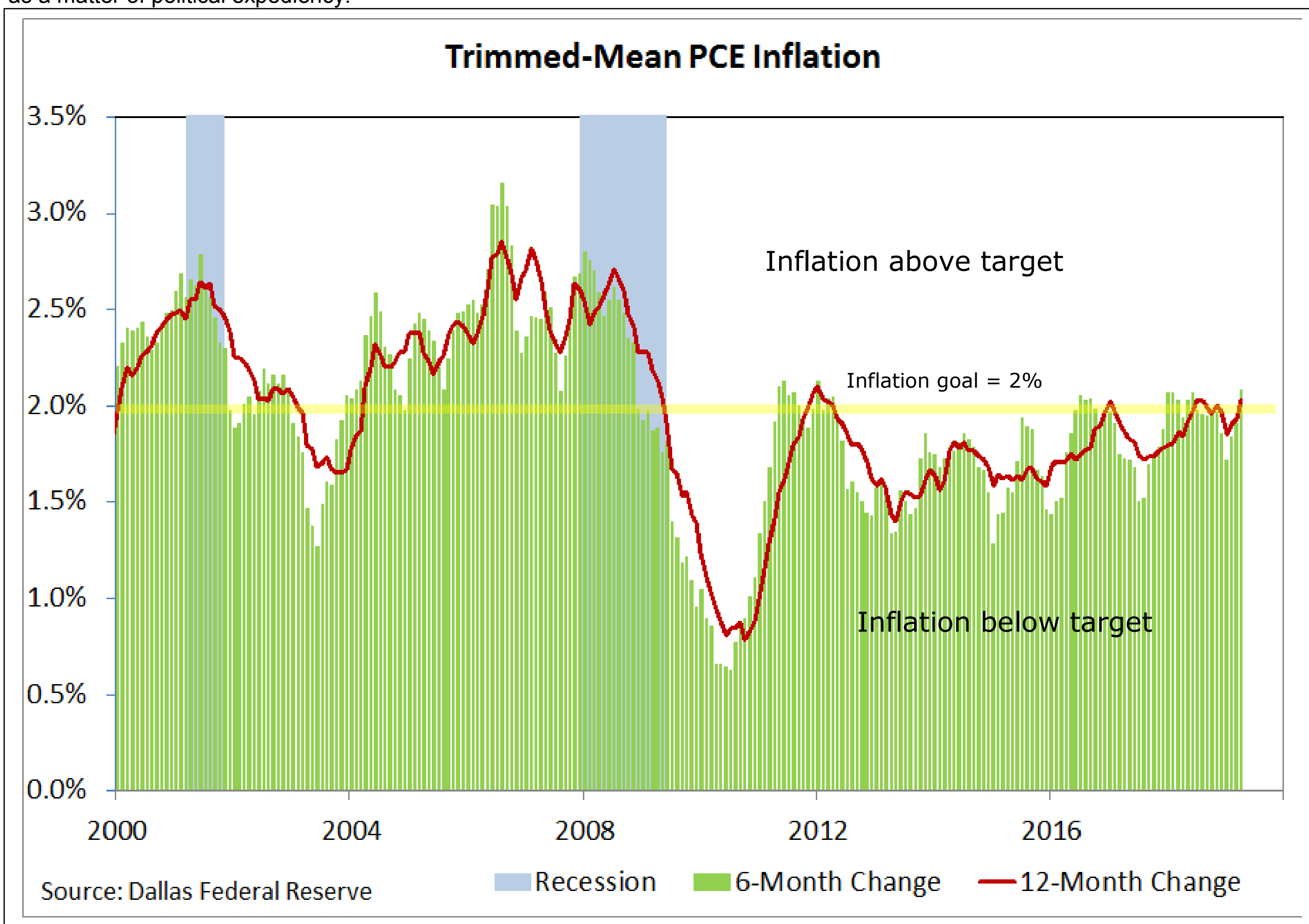
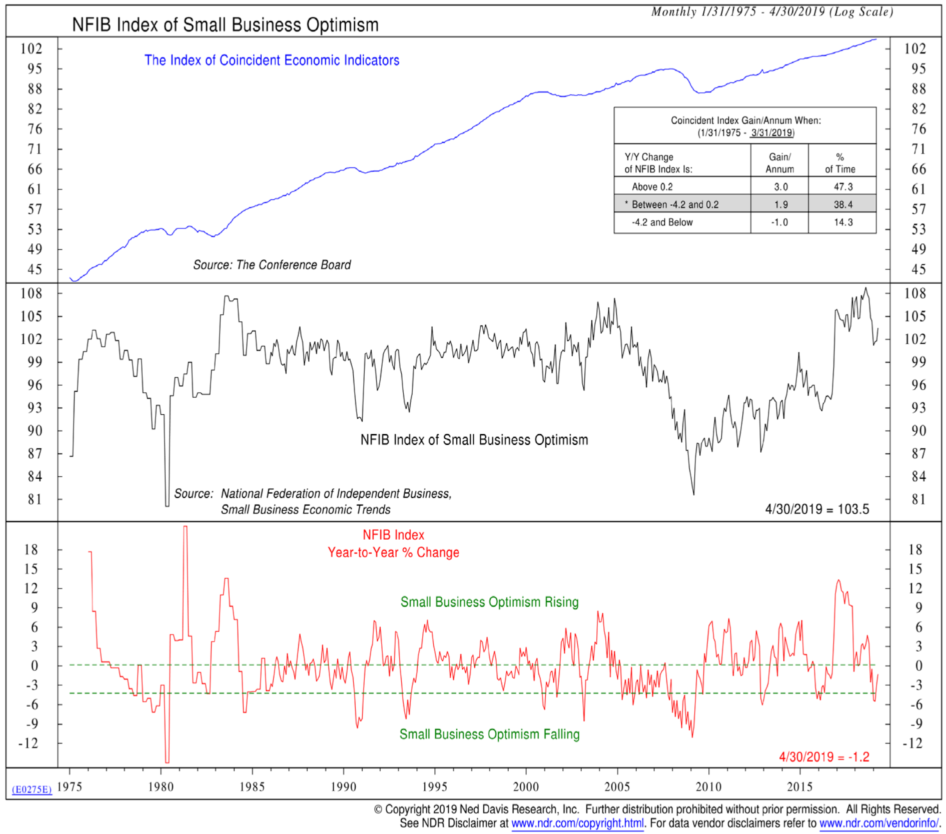
Yields on both the 2-year and 10-year T-Notes have fallen by more than one percentage point since late 2018 and are at their lowest levels since 2017. The drop in yields has accelerated over the past month, echoing the view expressed in the fed funds futures market that rate cuts are imminent. One of the arguments in favor of an "insurance" cut is that inflation has been undershooting the Fed's target. Core PCE inflation has weakened, but other measures of inflation (the Dallas Fed's Trimmed-Mean measure has been cited by multiple Fed officials) have been more stable. While this may appear to be goal post shifting on the part of the Fed, the academically rigorous Trimmed-Mean PCE does a better job of discerning inflation trends than does the core index, which emerged as a matter of political expediency.



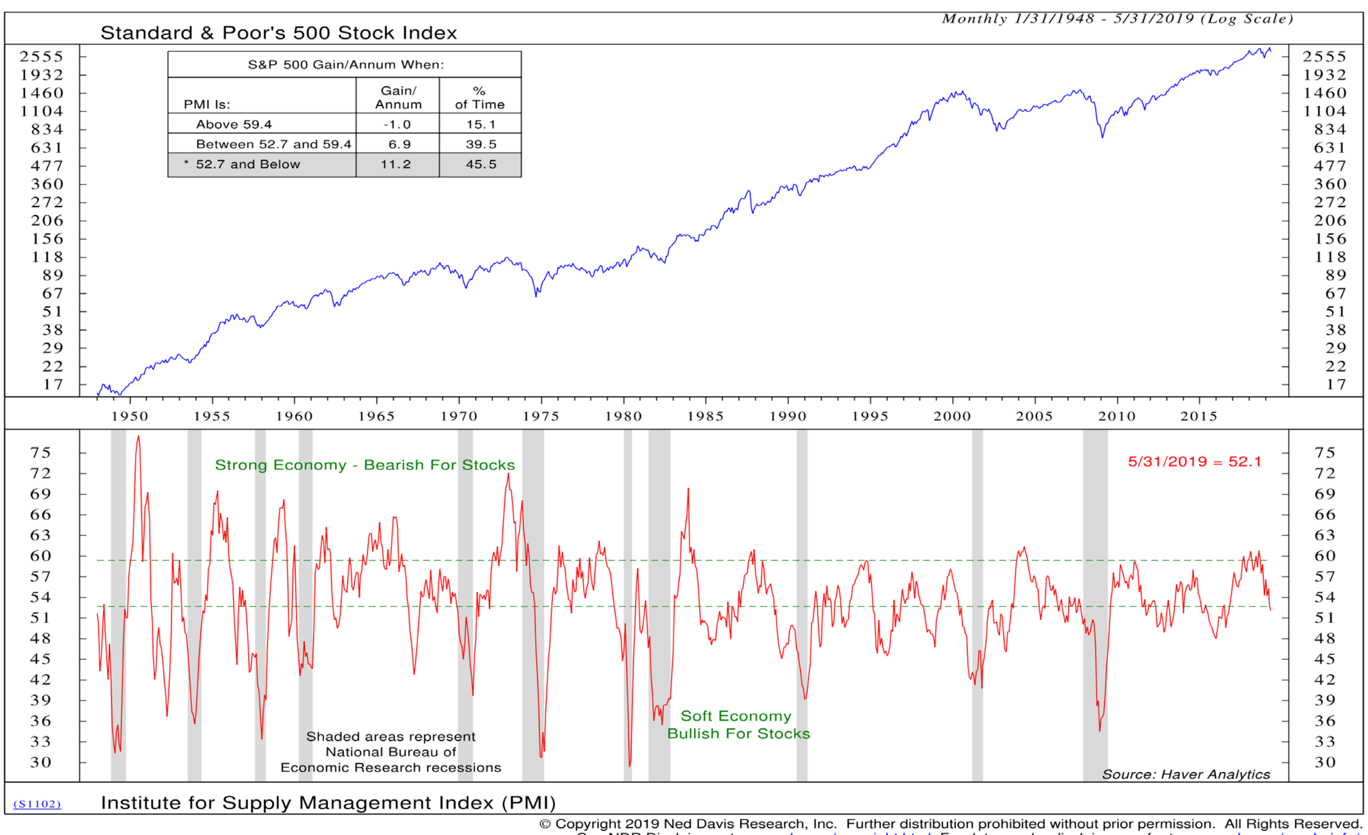
Source: Stock Charts



Expectations about the fallout from trade tensions have moved ahead of the data (helping explain the disconnect between the market the Fed). This increased uncertainty comes at a time when U.S. growth was already moderating and global economic conditions remained fragile. While it is true that all recessions have come with deterioration in the Purchasing Managers Index (PMI), only a fraction of all instances of PMI weakness have occurred within the context of a recession. It is also worth noting that stocks actually do well in periods of less than robust growth as measured by the PMI. We will continue to watch economic confidence indexes for evidence that cyclical slowing is morphing into something worse. So far this has not been seen, and both small business and consumer confidence have actually rebounded recently.



Source: Ned Davis Research



Source: Ned Davis Research

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