MARKET INSIGHTS

MACKENZIE Investments

Mackenzie Fixed Income Team November 15, 2019

Global Macroeconomic Update

Dustin Reid, MBA
Chief Fixed Income Strategist
Mackenzie Fixed Income Team

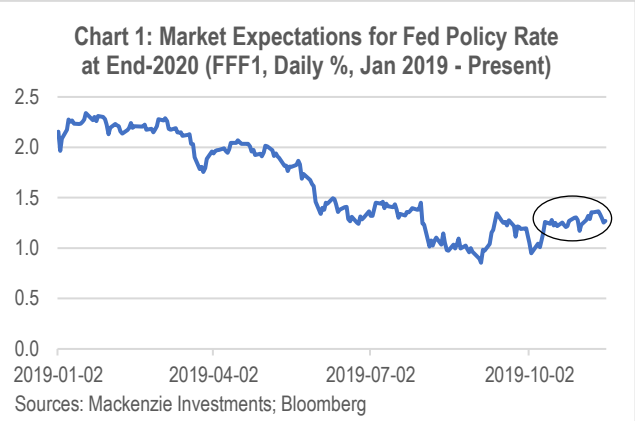
Key themes:

- The Fed is most likely on hold for the next six months, starting at its December meeting
- The market is beginning to understand more about how this Fed intends to conduct monetary policy for the next leg of the cycle
- In our view, curves should steepen in 2020 if the Fed outlines and is successful achieving a change to its inflation framework, opting to run inflation "hot" for a prolonged period

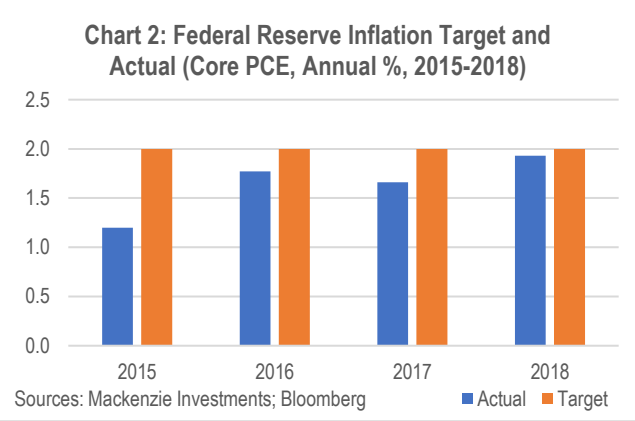
The Santa Pause

The October 30 Federal Open Market Committee meeting coupled with Fedspeak over the past week has helped to solidify what, we believe, the Fed is likely thinking and doing in terms of policy action in the coming months and quarters – a key driver for markets.

Clearly the first takeaway has been, without an unexpected catastrophic event, the Fed believes it will be on hold for the foreseeable future. It seems that the Fed views the 75bp worth of easing instituted year-to-date is enough for a mid-cycle adjustment and needs time to work its way through the economy. The market has in fact obliged, since the messaging began in the weeks ahead of the meeting with only about 25bp worth of easing priced through the end of 2020 (chart 1).



The second is the bar to easing fed funds has now been raised. The Fed clearly believes it has done enough to be accommodative in terms of policy and it would need to see (or expect) a significant downdraft in domestic data, tighter financial conditions or a material deceleration in the global outlook from current levels to resume its easing cycle. Conversely, the bar to hiking rates is even higher.



The third takeaway, mostly from Fed Chairman Powell's Joint Economic Congressional testimony, is a slight acknowledgement the Fed may have moderately overtightened in 2018. In particular Powell's reference to the natural rate of full employment possibly being lower than the Fed had previously estimated potentially suggests at least a small acknowledgement of overtightening. This is important, since seeking to maximize "full employment" is one of the Fed's mandated goals from Congress.

The final main point of interest was FOMC Vice-Chair Clarida's comments around the "make up" strategy for inflation. As we've previously noted please see *Symmetry*: February 28, 2019 , the Fed has been undergoing a review of its policy framework – particularly on inflation – since 2018. That review has been chugging along throughout the year and Clarida's public and slightly more detailed comments on the topic suggest the Fed is making some headway with Clarida saying a mid-year 2020 update from the Fed is possible.

We continue to believe markets are not ascribing as much focus on this last issue as it should, but it remains front-and-centre for the Mackenzie Fixed Income team. We believe the Fed will adjust its inflation metric towards something like an "Average Inflation Targeting" framework. This essentially means the Fed would try and "make up" for undershooting its inflation target in previous years (chart 2) in the future – in other words, "run inflation hot." This is very important for all asset markets, in particular fixed income, as it means the Fed's reaction function going into the next cycle will likely not be the same as it was for previous cycles; moreover, it likely means that policy rates will remain lower for longer in order to help boost

core PCE inflation (the Fed's preferred target) above 2.5% y/y on a sustained basis. If true, we could see increased buying in the 5-year area of the US curve and, coupled with our views for possible fiscal stimulus globally (please see *Circuit Breaker*. August 8, 2019) steeper curves in 2020.
