Fed Chair Powell pivots to cutting mode

Chair Powell could have been super balanced, or even hawkish. But he effectively chose to endorse the market discount for a rate-cutting phase ahead. It's had quite the reaction. Risk assets are up, the dollar down, so's the front-end yield. Watch longer tenor yields though - the deep thinkers of the bond market, and not quite convinced cuts are all good

Fed Chair, Jerome Powell

Front end yields down but back end yields not as comfortable

Chair Powell at Jackson Hole:

"Risks to inflation are tilted to the upside, and risks to employment to the downside—a challenging situation. He noted that when our goals are in tension like this, our framework calls for us to balance both sides of our dual mandate. Our policy rate is now 100 basis points closer to neutral than it was a year ago, and the stability of the unemployment rate and other labour market measures allows us to proceed carefully as we consider changes to our policy stance. Nonetheless, with policy in restrictive territory, the baseline outlook and the shifting balance of risks may warrant adjusting our policy stance."

Chair Powell was more dovish than we in rates strategy thought he'd be. He did not object to a rate cut at all. Obviously, he is keeping his options open, but the key move was the downsizing of

the tariff-induced inflation risk, mostly on account of a weakening labour market. The big impact market reaction to "*shifting risks may warrant adjusting policy*" mostly reflected a growing market fear into the speech that Powell could have been outright hawkish. Front-end yields are lower in yield (sub-3.7%), likely structurally. The 10yr yield too (nearing 4.25%). And the probability for a September cut is back up to 90%, having been at sub-70% prior to his speech.

There is a clear yield curve steepening impulse from this. The front end now has Chair Powell on its side, and yields there should stay down. The market is anticipating an ultimate move towards 3% for the effective fund rate, so the 2yr at 3.7% is still some 70bp above this future floor. The long end is not loving this, though. The 30yr yield is back up to where it was at 4.9%. This likely reflects a suspicion that the Fed could be taking risks with inflation here.

The renewed threat this morning from President Trump to fire Fed governor Lisa Cook (for allegedly falsifying bank documents) is another ingredient to consider, as the Trump quest to morph the Fed dovish continues. The front end won't care about this, as it is slavish to where the fund rate goes. But the back end is a deeper thinker, and can worry about second and third round effects, and especially on medium-term risks potentially being taken on inflation.

The net impact here is a steeper curve, and from both ends is shaping up as the likely prognosis ahead.

Dollar gets hit, and more to come

As soon as FX traders saw the headline reference to 'adjusting policy', the dollar came off sharply – falling nearly 1% against some of the major currencies. The speech supports the conclusions made after the July jobs report that the Fed could move in September after all. This speech comes at a time when the market has largely priced out expectations of any further easing from the ECB. And at a time when the market is seriously considering another rate hike from the Bank of Japan in October.

Lower short-dated US rates also feed into the narrative that foreign investors can increase their FX hedge ratios on their holdings of US assets. We've got targets of 1.17 and 145 for EUR/USD and USD/JPY at the end of this quarter. And if we're right about a series of Fed rate cuts into year-end, EUR/USD and USD/JPY could be trading 1.20 and 140, respectively.

EM high-yielding currencies, already favoured by global investors, should continue to do well too. Within the G10 space, we also think the activity currencies should outperform. Bullish steepening of the US yield curve is normally good for commodity currencies. We think AUD/USD could play a little catch-up here. And with equities continuing to do well, seemingly on a Fed cutting rates without a recession, the high beta and undervalued Scandinavian currencies should also do well.

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