Macro Strategy

DBS Focus

USD rates: Pause, not stop

Group Research

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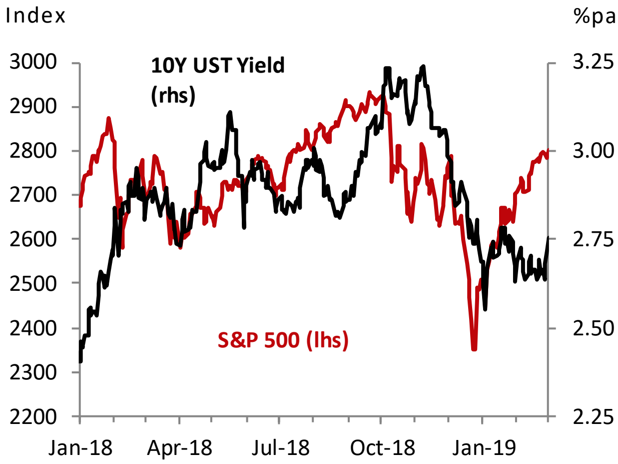
- *The Fed is on pause, but it is premature to conclude that the normalization cycle is done, and rate cuts are coming*
- *This pause is probably valid for a few quarters as the Fed seeks to sooth financial markets and to gauge global economic activity*
- *Financial conditions have eased significantly since December*
- *Global trade and PMI data are still on their year-long downtrend*
- *If a cyclical rebound takes place, USD rates would have to price in Fed hikes again, catching up to optimism in risky assets*

USD rates appear too pessimistic

We believe that the Fed has paused, not stopped, its normalisation cycle. This respite is likely valid for a few quarters, beyond which, a resumption becomes likely if macroeconomic data and market conditions hold up. Below, we lay out our framework for analysing the Fed, covering financial conditions, global trade data and US data and reiterate that there is a reasonable chance for Fed hikes to come into play again in 2H19.

4Q18 turned out to be the turning point for markets. Up till then, the US stock market had outperformed the world despite twin-tightening (Fed hikes and balance sheet run-down). USD rates were also rising in anticipation of another two-to-three hikes in 2019. That changed when financial conditions tightened significantly as credit spreads blew out and the stock market tanked. **Stress in the financial market is probably the single most relevant reason why the Fed had a dovish pivot in December/January.**

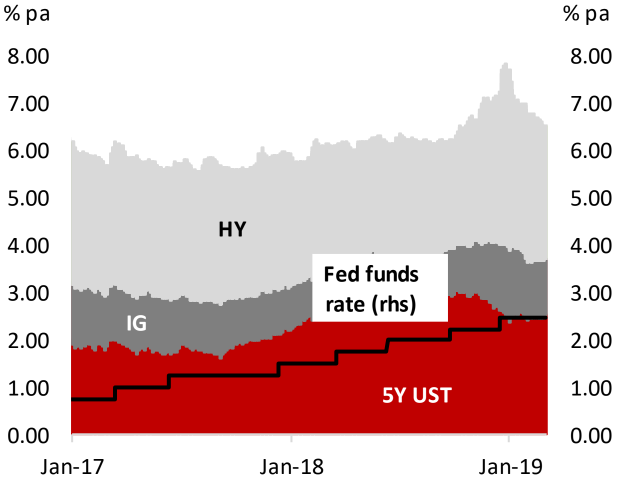
Pessimism faded in stocks but not US Treasuries



Source: Bloomberg

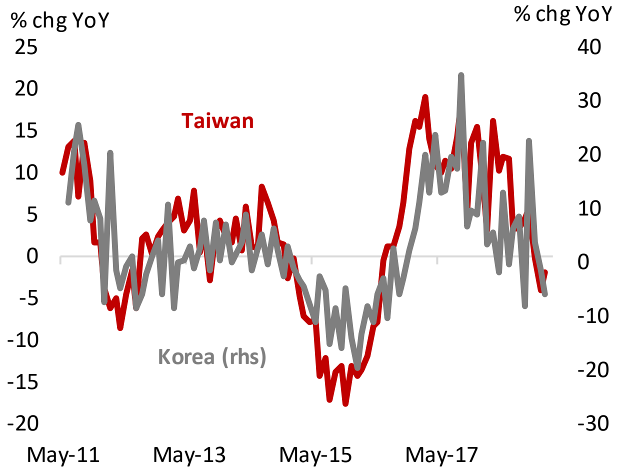
The market is no longer an impediment to further tightening. Notably, the S&P 500 has recouped over 80% of its decline from peak while the VIX has dropped below 15, levels not seen since early October. Credit spreads

Tightness in USD rates space has eased



Source: Bloomberg

Korea & Taiwan exports not turning around yet



Source: Bloomberg, CEIC, DBS

have re-tightened and with UST yields still significantly off highs, it can be argued that a fair amount of monetary loosening has already taken place. Much of this can be attributed to the Fed's emphasis on pause (scaling down of rate hike expectations and re-consideration of the balance sheet run-off) and we argue that **caution on the Fed's part has probably reduced the chances of a recession over the next twelve months.**

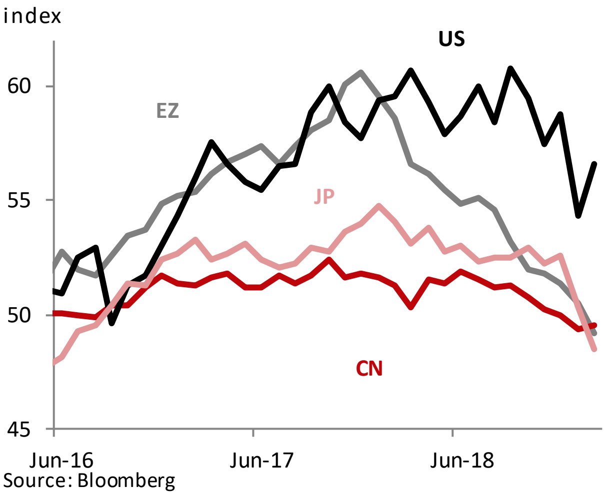
At this point, still-weak global data is probably the largest hurdle for further hikes. The global economy entered a synchronised slowdown in 2018 and there has been no clear signs that a bottom has been reached. We focus largely on manufacturing PMIs and export data to gauge global growth. Manufacturing PMIs across US, Eurozone, Japan and China are still trending down. Meanwhile, February PMIs for the more export sensitive economies – Korea and Taiwan are still firmly below 50. Exports data across the region paint a similar picture.

Economies which tend to be more dependent on trade (Korea, Taiwan, Japan, Malaysia, Vietnam and Thailand) are still showing depressed export growth numbers.

The takeaway is that the world has been in an electronics-induced manufacturing / export slump for an extended period. **We should be mindful that weak data is in the rear-view mirror and that another cyclical uplift could be around the corner.** There are early signs that the Chinese economy may be stabilising. Aggregate financing numbers released in February point to a surge in credit growth which may herald a bottoming out of economic activity. Economies with close linkages to China should also benefit and we may yet see a modest cyclical lift in the coming months.

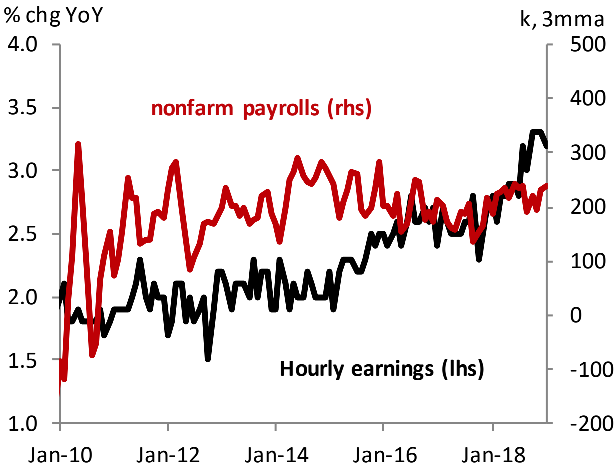
Lastly, we are not unduly worried about the US economy. While it is clear that we are in the late stages of the current expansion, this late stage has probably been extended by the Fed pivot and subsequent easing

Manufacturing PMIs still trending down



Source: Bloomberg

Hourly Earnings & Core CPI



Source: Bloomberg

of financial conditions. To be sure, housing data has softened somewhat, and manufacturing data has been mixed. CPI numbers are also coming off a high base at a time when oil prices are still relatively low (compared to the average in 2018). However, the labour market is still firm (creating an average of 240k jobs over the past three months) and wages are rising. The balance of risk for the US economy could tilt to the upside once global data starts to improve.

A Fed pause does not equate to an end in the rate hike cycle, nor does it necessarily imply that cuts will be forthcoming shortly after. The market would likely re-price in Fed hikes once global data improves meaningfully, thereby reducing downside risks to the US economy. As such, **there could be scope for a bit more steepening in the UST curve, catching up with some of the stock market optimism** that has been in play in recent weeks.

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Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).