Economics & Strategy

DBS Focus

Fed's dovish tilt and market implications

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- *The US FOMC has taken one more step toward signalling an end to its rates normalisation cycle*
- *The economic projections made by FOMC members are lower than they were just a couple of months ago*
- *The median projections now suggest lower growth in 2019 (2.1% vs 2.3% in December projections) and lower inflation (1.8% vs 1.9%)*
- *Following this, projection of Fed Funds rates has been revised down to no further hikes this year (compared 2 hikes projected in December)*
- ***We are also removing our Fed policy rate projections, expecting no further hikes both in 2019 and 2020***
- *Additionally, the pace of balance sheet normalisation will be slowed. The cap in monthly redemptions of treasury holdings will go to USD15bn beginning in May (from USD30bn)*
- *This and other tweaks will leave the Fed balance sheet steady at around USD3.5trln later this year*
- *These moves will support US treasuries*
- *That will in turn help emerging markets, both with respect to liquidity conditions and cost of financing*
- ***The Fed's implicit signal is that it over the near term it may well take a relaxed view about inflation; this could cause the yield curve to steepen eventually***
- ***The US dollar has sold off already in expectations of Fed's dovish views, but we don't see sustained dollar weakness ahead***
- *This is because both China and Europe have several idiosyncratic headwinds in play, keeping their respective exchange rates under pressure.*
- *If the fiscal stimulus in China and developments in the China-US trade talks stabilise global demand and sentiments, the Fed may come across as having blinked too early.*

Economics

Conventional wisdom in the markets used to be "don't fight the Fed." However, over the past decade or so, the US central bank has repeatedly scaled back its expectation of growth and inflation, and displayed acute sensitivity to the performance of asset markets. Perhaps the Fed now believes "don't fight the markets."

The March 20 FOMC decision reveals a bit more dovish view of the growth and inflation outlook, but they are not that material. After all, the economic projections are only 0.2% lower (2.1% vs 2.3% made in December) and even more modest for inflation (1.8% vs 1.9%). But between the line, we are picking up a more profound signal—which is that despite strong wage growth and rebounding commodity prices, the Fed will take a relaxed attitude if inflation were to pick up again. If true, this would mark a major departure in the monetary policy stance. We think that Fed communication will be increasingly focused on this area; having undershot its inflation target year after year, a bit of overshoot will be overlooked by the Fed in 2019 and 2020.

In our rates section, we consider the implication of this line of signalling. Right now, the fixed income market is rallying, but could the long-end eventually sell off as inflation bottoms, fiscal deficit remains large, and demand for long duration assets wane? We think this is quite possible, and not at all priced by the market.

Fed's dovish move extends beyond dot plots. Strikingly, the Fed has made clear that the pace of balance sheet normalisation will be slowed. The cap in monthly redemptions of treasury holdings will go to USD15bn beginning in May (from USD30bn). This and other tweaks will leave the Fed balance sheet steady at around USD3.5trln later this year.

These measures are going to provide crucial support to emerging markets, in our view. Liquidity conditions and cost of financing, both of which were sources of major headwind last year for EM rates and credit, will fade. But the eventual steepening of the US yield curve that we are envisaging could complicate the long-term funding picture eventually.

These market pleasing developments have fuelled rallies in EM assets already, but how sustainable is that? We note that both China and Europe have several idiosyncratic headwinds in play, which form negatives for their markets and economies. For China, these include the negative spill-over from its debt overhang and weak domestic sentiments. For Europe, they range from Brexit to complicated politics in France, Germany, Italy, and Spain. Hence, we are not expecting a sharp selloff in DXY.

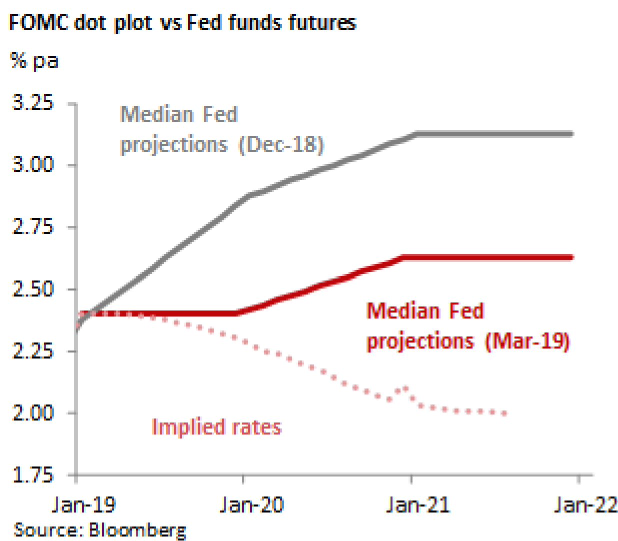
We feel that Western central banks still do not fully appreciate the impact of China on their growth and inflation outlook. Perhaps the reaction function of policy makers should give higher weight to China's demand and price conditions, as they seem to be the best early warning indicators of the global cycle. With that mind, If the ongoing fiscal stimulus in China and positive developments in the China-US trade talks stabilise global demand and sentiments, the Fed may come across as having blinked too early.

Rates: The Fed cements the dovish pivot

The Fed unleashed another dovish surprise, cementing its dovish pivot that took place in December/January. The dot plot (here) now shows just one hike in 2020, compared to three (two in 2019 and one in 2020) back in December. Market participants were mostly anticipating the Fed to retain one hike in 2019. Clearly, the Fed's focus has shifted towards supporting the economy and further normalisation is no longer a priority, hence an extended pause. For all intents and purposes, an extended pause equals a stop in the tightening cycle and USTs rallied across all tenors, with 10Y yields now hovering just above 2.50%. Meanwhile, the balance sheet runoff is set to slow (here) in May and will cease by September leaving the Fed's balance sheet at around USD3.5tn. There will also be tweaks in the composition of Fed holdings towards US Treasuries as principal payments from agency debt and MBS come in.

We think that USTs will be supported for the foreseeable future as the hurdle for another hike appears to be quite high. The market is even more aggressive and has fully priced in a 25bps cut by mid-2020. Accordingly, we have adjusted our forecasts and anticipate the Fed to stay on hold through to end-2020.

FOMC dot plot vs Fed funds futures



Source: Bloomberg

With developed markets leaning towards further easing, the situation is reminiscent of 2015/16 where the Fed was unable to hike as much as it wanted to. The timely and aggressive pivot from the Fed has eased financial conditions and should cushion the slowdown in the US economy. Recession risks may start receding (leading to a steeper UST curve) as it becomes clear that the Fed stance is now tilted towards supporting the economy.

For Asian assets, the decline in USD rates is undeniably positive. High-yielding govvies (Indonesia, India and the Philippines) have had a good rally since the start of the year and will likely see yields gap lower when markets open. The impact should also be sizable in the lower-yielding economies. With the Fed signalling an extended pause, rate cut bets should build across Asian economies, especially those where real rates are still elevated (Indonesia, India, Philippines, Malaysia). Previously, we thought that shorter-duration Asian govvies may be the best way to express this view. Now we think that it may make more sense to extend some duration risks (out to the 5Y tenor) given a more benign Fed outlook and the fact that curves have steepened.

FX: Volatility to increase post-FOMC

The US dollar index (DXY) has been flat this year, but weakened in recent weeks as dovish Fed policy views were cemented. We don't think the USD will keep depreciating from here. The US 10Y bond yield has fallen to 2.52%, just above the ceiling of the Fed Funds Rate currently at 2.25-2.50%, suggesting that the extended Fed pause has been mostly priced in.

Conversely, other central banks are likely to ease monetary policy before the Fed. The markets are pushing for a rate cut in Australia. The Philippines is looking to lower reserve requirement ratio by 400 bps over four quarters. The central banks in Eurozone and Japan are unlikely to hike rates next year. Only last week, the European Central Bank's decision to provide more liquidity to banks via targeted longer-term refinancing operations (TLTROs) took markets by surprise.

For emerging Asian currencies, an extended Fed pause is considered a double-edged sword. While emerging markets are relieved that there will be no more US rate hikes this year, they are also uneasy with a more synchronized global economic slowdown. Historically, currency volatility has increased during tail end of a Fed hike cycle and the transition from a half-full to half-empty global outlook. Two unpredictable event risks – a disorderly Brexit and US-China trade tensions – are unresolved and have potential to hurt currencies in 2Q19. In conclusion, the Fed's extended pause has not only dampened the appetite for the USD, but also tainted the allure of other exchange rates banking on a global recovery.

Key Forecasts

	GDP growth, % YoY				CPI inflation, % YoY, ave			
	2017	2018e	2019f	2020f	2017	2018e	2019f	2020f
China	6.9	6.6	6.2	6.0	1.6	2.1	2.3	2.3
Hong Kong	3.8	3.3	2.5	2.0	1.5	2.5	2.7	2.5
India*	7.1	6.7	7.1	7.4	4.5	3.6	3.5	3.8
Indonesia	5.1	5.2	5.2	5.1	3.8	3.2	3.6	3.6
Malaysia	5.9	4.7	4.5	4.2	3.8	1.0	1.7	1.6
Philippines**	6.7	6.3	6.5	6.4	2.9	5.2	3.9	3.8
Singapore	3.9	3.2	3.0	2.8	0.6	0.4	1.8	1.5
South Korea	3.1	2.7	2.6	2.4	1.9	1.5	1.1	1.5
Taiwan	3.1	2.6	1.9	1.8	0.6	1.3	0.7	1.0
Thailand	3.3	4.1	3.8	4.0	0.7	1.1	1.0	1.3
Vietnam	6.8	7.1	6.6	6.3	3.5	3.5	3.8	3.4
Eurozone	2.5	1.9	1.2	1.5	1.5	1.8	1.2	1.3
Japan	1.9	0.7	0.7	0.5	0.5	1.0	1.1	1.6
United States***	2.3	2.9	2.5	1.5	2.1	2.4	1.5	1.5

* refers to year ending March ** new CPI series *** eop for CPI inflation

Policy interest rates, eop

	1Q19	2Q19	3Q19	4Q19	1Q20	2Q20	3Q20	4Q20
China*	4.35	4.35	4.35	4.35	4.35	4.35	4.35	4.35
India	6.25	6.00	6.00	6.00	6.00	6.00	6.00	6.00
Indonesia	6.00	6.00	6.00	6.00	6.00	6.00	6.00	6.00
Malaysia	3.25	3.25	3.25	3.25	3.25	3.25	3.00	3.00
Philippines	4.75	4.75	4.75	4.75	4.75	4.75	4.75	4.75
Singapore**	1.95	1.95	1.95	1.95	1.95	1.95	1.95	1.95
South Korea	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75
Taiwan	1.38	1.38	1.38	1.38	1.38	1.38	1.38	1.38
Thailand	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75
Vietnam***	6.25	6.25	6.25	6.25	6.00	5.75	5.75	5.75
Eurozone	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Japan	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10
United States	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50

* 1-yr lending rate; ** 3M SOR ; *** prime rate

Exchange rates, eop

	Mar 20	Q2 19	Q3 19	Q4 19	Q1 20	Q2 20	Q3 20	Q4 20
China	6.69	6.85	7.00	6.95	6.90	6.85	6.80	6.75
Hong Kong	7.85	7.85	7.85	7.84	7.83	7.82	7.81	7.80
India	68.6	70.0	71.0	71.5	71.0	70.5	70.0	69.5
Indonesia	14086	14300	14500	14400	14300	14200	14100	14000
Malaysia	4.06	4.10	4.20	4.25	4.20	4.15	4.10	4.05
Philippines	52.8	54.0	55.0	54.5	54.0	53.5	53.0	52.5
Singapore	1.35	1.37	1.40	1.39	1.38	1.37	1.36	1.35
South Korea	1126	1135	1145	1140	1135	1130	1125	1120
Thailand	31.7	32.5	33.0	32.8	32.6	32.4	32.2	32.0
Vietnam	23207	23250	23300	23280	23300	23250	23200	23150
Australia	0.71	0.70	0.68	0.68	0.68	0.69	0.70	0.71
Eurozone	1.14	1.12	1.10	1.11	1.12	1.13	1.14	1.15
Japan	111	113	115	114	113	112	111	110
United Kingdom	1.32	1.30	1.28	1.29	1.30	1.31	1.32	1.33

Australia, Eurozone and United Kingdom are direct quotes

Rates forecasts

		2019				2020			
		Q1	Q2	Q3	**Q4**	Q1	Q2	Q3	**Q4**
US	3m Libor	2.70	2.70	2.70	**2.70**	2.70	2.70	2.70	**2.70**
	2Y	2.45	2.45	2.50	**2.50**	2.50	2.50	2.50	**2.50**
	10Y	2.55	2.55	2.60	**2.65**	2.70	2.70	2.70	**2.70**
	10Y-2Y	10	10	10	**15**	20	20	20	**20**
Japan	3m Tibor	0.05	0.05	0.05	**0.05**	0.05	0.05	0.05	**0.05**
	2Y	-0.15	-0.15	-0.15	**-0.15**	-0.13	-0.10	-0.07	**-0.05**
	10Y	0.00	0.03	0.05	**0.07**	0.10	0.13	0.15	**0.15**
	10Y-2Y	15	18	20	**22**	23	23	22	**20**
Eurozone	3m Euribor	-0.30	-0.30	-0.30	**-0.30**	-0.30	-0.30	-0.30	**-0.30**
	2Y	-0.55	-0.55	-0.55	**-0.55**	-0.55	-0.55	-0.50	**-0.50**
	10Y	0.10	0.10	0.10	**0.10**	0.10	0.15	0.20	**0.25**
	10Y-2Y	65	65	65	**65**	65	70	70	**75**
Indonesia	3m Jibor	7.20	7.20	7.20	**7.20**	7.20	7.20	7.20	**7.20**
	2Y	7.00	6.90	6.80	**6.70**	6.70	6.70	6.70	**6.70**
	10Y	7.80	7.70	7.60	**7.50**	7.50	7.50	7.50	**7.50**
	10Y-2Y	80	80	80	**80**	80	80	80	**80**
Malaysia	3m Klibor	3.65	3.65	3.65	**3.65**	3.65	3.65	3.40	**3.40**
	3Y	3.35	3.35	3.35	**3.35**	3.35	3.35	3.20	**3.20**
	10Y	3.75	3.80	3.85	**3.90**	3.95	3.95	3.90	**3.90**
	10Y-3Y	40	45	50	**55**	60	60	70	**70**
Philippines	3m PHP ref rate	5.55	5.55	5.55	**5.55**	5.55	5.55	5.55	**5.55**
	2Y	5.75	5.75	5.75	**5.75**	5.75	5.75	5.75	**5.75**
	10Y	6.00	6.00	6.00	**6.00**	6.00	6.00	6.00	**6.00**
	10Y-2Y	25	25	25	**25**	25	25	25	**25**
Singapore	3m Sibor	1.95	1.95	1.95	**1.95**	1.95	1.95	1.95	**1.95**
	2Y	2.00	2.00	2.00	**2.00**	2.00	2.00	2.00	**2.00**
	10Y	2.15	2.15	2.18	**2.20**	2.20	2.20	2.20	**2.20**
	10Y-2Y	15	15	18	**20**	20	20	20	**20**
Thailand	3m Bibor	1.85	1.85	1.85	**1.85**	1.85	1.85	1.85	**1.85**
	2Y	1.80	1.80	1.80	**1.80**	1.80	1.80	1.80	**1.80**
	10Y	2.40	2.40	2.50	**2.60**	2.60	2.60	2.60	**2.60**
	10Y-2Y	60	60	70	**80**	80	80	80	**80**
China	1 yr Lending rate	4.35	4.35	4.35	**4.35**	4.35	4.35	4.35	**4.35**
	3Y	2.90	2.80	2.80	**2.80**	2.80	2.80	2.80	**2.80**
	10Y	3.20	3.15	3.10	**3.15**	3.20	3.25	3.25	**3.25**
	10Y-3Y	30	35	30	**35**	40	45	45	**45**
Hong Kong	3m Hibor	2.00	2.00	2.00	**2.00**	2.00	2.00	2.00	**2.00**
	2Y	1.70	1.70	1.70	**1.70**	1.70	1.70	1.70	**1.70**
	10Y	1.85	1.85	1.90	**1.95**	2.00	2.00	2.00	**2.00**
	10Y-2Y	15	15	20	**25**	30	30	30	**30**
Korea	3m CD	1.90	1.90	1.90	**1.90**	1.90	1.90	1.90	**1.90**
	3Y	1.80	1.80	1.80	**1.80**	1.80	1.80	1.80	**1.80**
	10Y	2.00	2.00	2.10	**2.10**	2.10	2.10	2.05	**2.05**
	10Y-3Y	20	20	30	**30**	30	30	25	**25**
India	3m Mibor	7.35	7.00	6.90	**6.80**	6.70	6.70	6.70	**6.70**
	2Y	6.80	6.65	6.50	**6.50**	6.50	6.50	6.50	**6.50**
	10Y	7.30	7.40	7.50	**7.50**	7.50	7.50	7.50	**7.50**
	10Y-2Y	50	75	100	**100**	100	100	100	**100**

%, eop, govt bond yield for 2Y and 10Y, spread bps

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