Economics

DBS Focus

Fed and PBOC ease over the weekend; underscores severe ongoing economic slowdown

Economics/Growth/Monetary/Rates

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- *A week of historic market turbulence has prompted emergency measures from policy makers across the world*
- *The Fed has cut rates to zero and re-embarked on QE while the PBoC has reduced RRR further*
- *While aggressive policies are needed, we see three key risks ahead*
- ***Implication to markets**: Expect volatility as the market grapples with a sharp global economic slowdown, the limits of monetary policy and increasing fiscal responses*

After a week of historic asset market turbulence and myriad policy intervention (see table below), including this morning's 100bps rate cut by the US Federal Reserve and RRR cuts from the People's Bank of China (PBoC), we continue to see three key risks ahead:

First, the combination of market correction and economic slowdown, despite Fed QE, will continue to push up corporate debt spreads, causing a negative feedback loop between the real and financial sector.

Fed measures

Fed funds rate cut by 100bps

RRR cut to zero

QE of at least USD 700bn

Better terms for discount window

Provide USD via swap lines

PBoC measures

RRR cut by 50-100bps for selected banks. Joint-stock commercial banks get additional reduction of 100bps

Second, insufficient or poorly communicated public policy response to the outbreak will perpetuate consumption and investment uncertainty, as well as compound distress in the corporate sector.

Third, the combination of risk aversion and commodity price collapses would push energy exporting economies (in particular) and emerging markets (in general) to experience sudden stop in capital flows, paving the ground for rolling economic crises.

Below we lay out the implications for global rates and FX.

Rates: Policymakers show hand

With the measures announced over the weekend, the Fed is back at the zerobound with the Fed funds target at 0-0.25%. Quantitative easing (QE), to the tune of USD 700bn (USD 500bn in USTs and USD 200bn in MBSs), has also been announced. Notably, the Fed's policy rate has practically converged with its G3 peers and we suspect that it is close to the limits on these policies. The European Central Bank (ECB) and Bank of Japan (BOJ) have been much more reticent on looser monetary policies (the ECB disappointed last week) in the current crisis amid increasing concerns on negative rates. **With monetary policy exhausted, fiscal policies will come to the fore.**

We think that these aggressive measures will help at the margin. **QE will boost liquidity in the system and will go some ways towards calming USTs.** Over the past week, longer-term USTs have seen intraday trading ranges in excess of 30bps. Moreover, the scramble for cash have hurt USTs even as risk-off takes hold. USTs should regain their role as a risk hedge and we expect DM yields to fall on Monday. More aggressive measures to calm credit markets and ensure firms / individuals tide through the coming few months will be welcome. At this point, **we would be watching the MOVE index (which tracks implied volatilities across USTs), the VIX, front-month FRA-OIS spreads, credit spreads to assess if the worst is over.** At this point, we think there will be a lot more volatility as risky assets price in a sharper global economic slowdown.

The silver lining is that policy makers are generally no longer complacent over COVID-19. Policy responses from the major central banks have been aggressive. Fiscal taps are being loosened (albeit not as fast the market wants) across the world. Containment efforts across countries have also stepped up significantly over the weekend. Amid the gloomy outlook and probably increasing negative news flow on the virus, **we should keep in mind that many of the necessary steps to support the economy and limit the worst of the virus has been done**. Hopefully, this will blunt the worst of the economic / financial impact in the coming months.

In Asia, conditions are likely to be similarly stressed. More monetary and fiscal support are likely to be in the offing. However, budgetary and monetary constrains bear watching in this volatile environment. With the 100bps Fed cut, there is technically more cover for Asia central banks to ease policy. However, the timing and magnitude of rates cuts in Asia may be more muted and / or delayed. Heightened volatility in IDR and INR assets could prompt their respective central banks to temporarily show some restraint. For economies that are already close to the zerobound (Thailand and Korea), we doubt that there is appetite to follow the Fed as aggressively. Against this backdrop, **Asia assets are likely to cheapen first, before recovering when financial conditions (USD funding worries) improve.**

China: Market rates to fall further on RRR cut

The reserve requirement ratio will be lowered by 50-100bps on Monday for all banks who meet certain criteria for lending to small- and mid-sized companies under the PBOC's inclusive finance program. Joint-stock commercial banks will get additional reduction of 100bps; together the cuts will inject RMB550bn into the system. Since January, the authority has strengthened counter-cyclical adjustments by cutting banks' RRR and launching a series of open market operations in succession. Ample liquidity has smoothed interbank interest rates. The 7-day repo rate has been lowered to the range of 2.2%-2.4% in February from as high as 2.9% in January. We expect funds released by the latest reserve ratio cut to drive money market rates lower and reduce banks' overall funding costs. Freeing up more liquidity to stimulate credit growth is crucial as data due on Monday will likely show the economy shrank in Jan-Feb. The impact on bonds and equity will, however, be marginal as the reduction has largely been priced in after the State Council meeting on March 10. Still, China's asset prices have vastly outperformed its global peers this month. Investors appear to have been reassured by Beijing's swift policy response to economic disruptions caused by the COVID-19 outbreak. SHCOMP was up 0.3% from end-February to March 13, while the S&P 500 plunged 8.2% over the same period. And when most currencies faced high volatility in the wake of a historic plunge in oil prices last week, the RMB index climbed to the highest level since May 2019. We expect this trend to continue as coronavirus in China wanes while other major economies are yet to see the worst.

FX: Fed's measures are no panacea for the rest of the world

The Fed's two inter-meeting rate cuts and QE this month are unlikely to set the USD on a downtrend yet, especially against the components of the DXY Index. A floor is still needed in the bear stock market worldwide. Futures are positioned for the Dow Jones to fall some 1000 points at tonight's open. The Fed's policy responses are considered a painkiller and not a panacea to the COVID-19 pandemic.

The Fed has also extended standing USD liquidity swap lines to the Bank of Canada, the Bank of England, the Bank of Japan, the European Central Bank and the Swiss National Bank. This was consistent with the fact that the number of COVID-19 cases in the rest of the world has overtaken China. Some Developed Market countries are still seen not doing enough to contain the coronavirus. Most have been more pre-occupied with preventing the coronavirus from entering their countries. Travel bans and border closures will lead to more supply disruptions and hurt consumption and investment.

EUR, which is the largest component in the DXY, is unlikely to shake off the fact that Europe has become the epicentre of the pandemic. EU nations are still not unified and coordinated in their responses to containing the coronavirus. With the Eurozone tumbling into recession, the pressure is growing for Brussels and the ECB to demonstrate the will to “do whatever it takes” to buffet the hold the single markets together. Hence, the risk remains for EURUSD to tread below 1.10 into the lower half of its QE range of 1.05-1.15.

Looking ahead, the Fed’s decision may draw the UK and Australia closer to QE. If so, GBPUSD and AUDUSD are set to test their key supports at 1.20 and 0.60 respectively. A firm USD against Singapore’s trade-weighted basket of currencies, especially the EUR and the CNY, will hold USDSGD above 1.40. Following the second Fed inter-meeting cut, Singapore is expected to end of the modest and gradual appreciation stance for the SGD policy. The odds have also increased for the SGD NEER policy band to be re-centred by 1-2% lower. A decision may come before the next scheduled policy review in mid-April.

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