Macro Strategy

DBS Focus

USD Rates: What will prompt the Fed to cut?

Group Research

May 14, 2019

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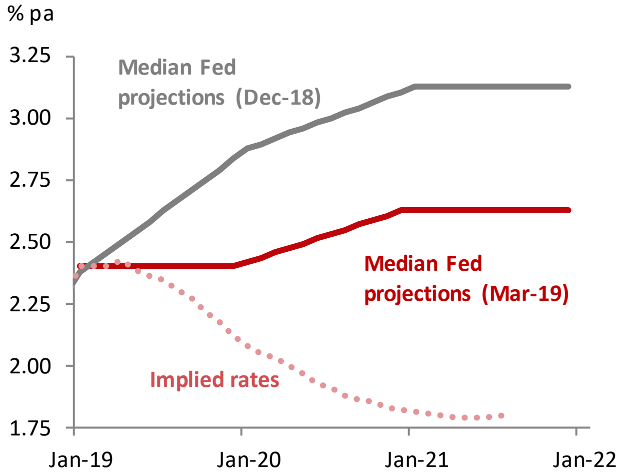
- *The divergence in market pricing and the Fed's dot plot bears watching*
- *The last time this development took place, the Fed capitulated into a pause*
- *We argue that conditions are not yet in place for Fed cuts, although expectations are shifting in that direction*
- *It would probably require an all-out China-US, a deterioration in US financial conditions or persistent weakness in global/US numbers.*
- ***Implications for forecast**: There are downside risks to our Fed funds rate forecasts if the trade war escalates*
- ***Implications for investment**: The USD rates space is already dovish. Unless there is conviction that a major US downturn is around the corner, it makes more sense to avoid duration risks*

USD Rates: What will prompt the Fed to cut?

Against the backdrop of escalating China-US trade tensions, USD rates are now pricing in three Fed cuts by end-2020 in contrast to a hike in the most recent dot plot. The last time the Fed and the market ran such divergent views was in late 2018 and the Fed nudged down the dot plot aggressively. Given that the market has a better track record and has proven to be timelier, it makes sense to consider the factors that would nudge the Fed towards easing.

Diverging FOMC dot plot and market views



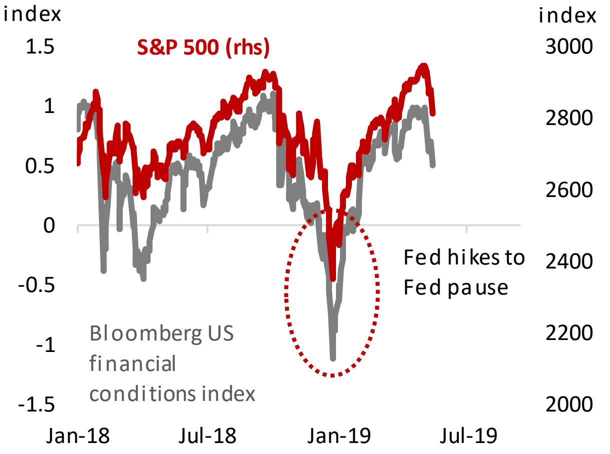
Source: Bloomberg

Below, we re-examine our framework of the Fed's reaction function and conclude that **conditions are yet not ripe for a Fed cut.** However, risks are clearly tilted to the downside. and **a further escalation in trade war** (US applying tariffs on all Chinese imports for example) **could provide enough justification for the Fed to deliver the 2-3 cuts that the market is already pricing in**.

The Financial Conditions angle

A deterioration in financial conditions (coupled with a weaker growth outlook) would be the most likely trigger to push the Fed towards easing. Before examining how this could play out, we note that **US economic fundamentals are still on sound footing**. Job creation is still robust and inflationary pressures are moderate. Under more benign circumstances, market participants would be focusing on the US being in a “Goldilocks” position. **In the rest of the world, recent data still showed weakness, but there have been signs of a stabilisation** in China and Eurozone data. However, this nascent recovery can easily be stifled by a full-blown trade war.

The Fed reacts to financial conditions



Source: Bloomberg, CEIC, DBS

Financial conditions can tighten via a few channels. In 4Q18, a combination of higher USD rates (worries about Fed tightening), collapsing stock markets and a firmer USD was sufficient to force the Fed into a pause, underscoring the Fed’s reaction function. This time round, USD rates are already low. **It would probably take another sharp fall in US stock indices (10-15% fall from peak) and / or another leg up in the DXY index to turn the Fed more dovish. These events could easily play out if the trade war worsens or spreads to other fronts** – more tariffs on goods, tariffs on services, investment restrictions, weaponizing currencies. Our assumption is that the Fed would be far more sensitive to downside risks to growth than the impact of higher prices from tariff increases.

There also appears to be a feedback loop of markets, macro and the urgency towards finding a trade deal. Firm macro numbers would imply that an economy is better placed to weather an extended trade war. It also helps if the stock market holds up. In which case, we would expect negotiations to take a much harder line. Conversely, falling stock markets might prompt both sides to seek a more market friendly outcome. **Unfortunately, this suggests that the stock market (in the US and China) needs to sell off a lot more before both sides become amenable to a deal.**

Implications on rates

The USD rates space is already dovish and there is no money to be made in buying USTs (<5Y) even if the Fed cuts three times. These cuts can be delivered if the China-US trade war worsens and / or the Fed decides to adopt a new framework to boost inflation expectations. **It would probably require a much larger shock (or expected shock) to the US economy** (>20% fall in US stock indices, further global economic weakness or softening in US data) **to drive the Fed to cut rates even more aggressively**. We reiterate that yields are already depressed at current levels and are arguably more susceptible to upside risks once there is any whiff of positive news. **Keeping duration risks short probably makes the most sense at this point**.

What are the bond and equity markets pricing in?

	Minor hike cycle (1-2 hikes): China-US trade deal, global data holds up, stocks rally, US core inflation ticks up
The equity market seems to be here	Extended pause: China-US trade deal, global and US data holds up
The USD rates market is here	**Minor cut cycle (2/3 cuts)**: elevated trade war, slowdown risks to the US economy, change in Fed's framework
	Major cut cycle (> 4 cuts): fullblown trade war, sharp recession risks to the US economy

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