Economics & Strategy

DBS Flash

FOMC to cut rates as insurance

Economics/Strategy/Rates

Group Research

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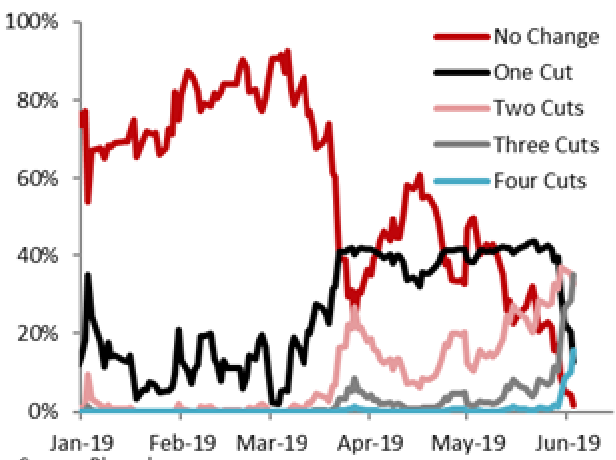
Futures-implied probability of Fed action by end-2019



Source: Bloomberg

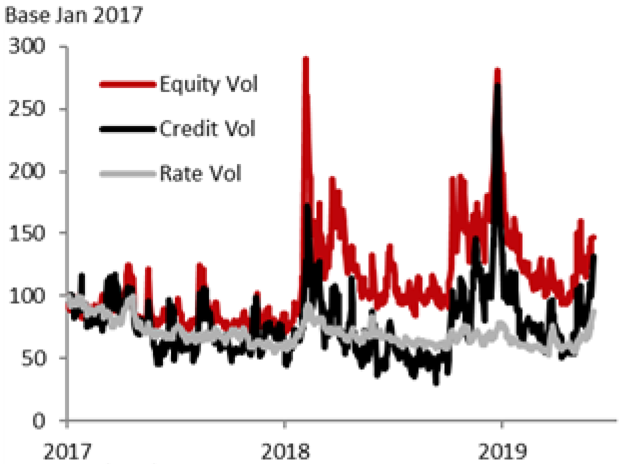
- *The list of downside risks to the global economy has lengthened considerably in the past month.*
- *They include sharp escalation in China-US trade wars, a considerable ratcheting up of US pressure on China's technological capabilities and potential, rising tension around Iran, US spat with Mexico on immigration, and the US broadening trade tensions vis-à-vis India and Europe, along with currency manipulation charges against some key economies.*
- *These have so far manifested in a worsening of global investment sentiments, a rise in fixed income market volatility, and some sell-off in equity markets.*
- *Equity and credit market volatility is primed to rise if the confluence of risks doesn't recede.*
- *Despite a strong labour market and healthy wage dynamic, a sharp selloff in financial markets would compel the US Fed to cut rates, in our view.*
- ***We now expect the Fed Funds rate going down by 25bps each in September and December, to be explained as insurance against global market risks and chronically below-target inflation.***
- *A last-moment resolution in trade wars on one side, and spike in inflation due to tariffs on the other side, would complicate Fed policy*
- *As lower for longer becomes the theme in the developed market space, investors will likely look to Asia for yield*

Rate cuts are coming, but will they help?

In the span of a month, our assessment of the global economic outlook has worsened considerably. A nascent recovery in trade and business sentiment has been undermined severely by an escalation and broadening of trade wars, progressively weak data prints, as well as a rise in geopolitical tension.

Granted, despite the recent selloff, equity and credit markets are not showing deep signs of distress, monetary conditions are not particularly challenging, there have been no major events to suggest liquidity support is warranted, and policy makers in key economies are already sounding very dovish. Hence there is no immediate case for a rate cut, especially in the US, where the labour market is tight and wage growth strong.

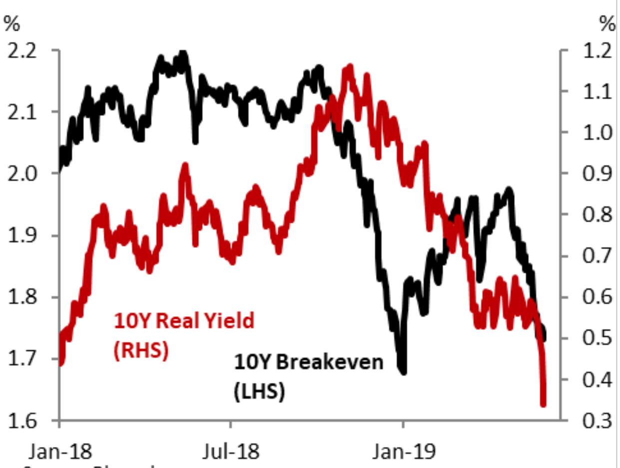
Implied Volatilities across Asset Classes



Source: Bloomberg

The fixed income market is pricing in a series of rate cuts nonetheless, predicated on the potential for lasting damage to the global economy from prevailing uncertainties, as well as the view that the real policy rate is too high at a time of ballooning downside risks and chronically below-target inflation.

10Y US Real Yield vs Inflation Compensation



Source: Bloomberg

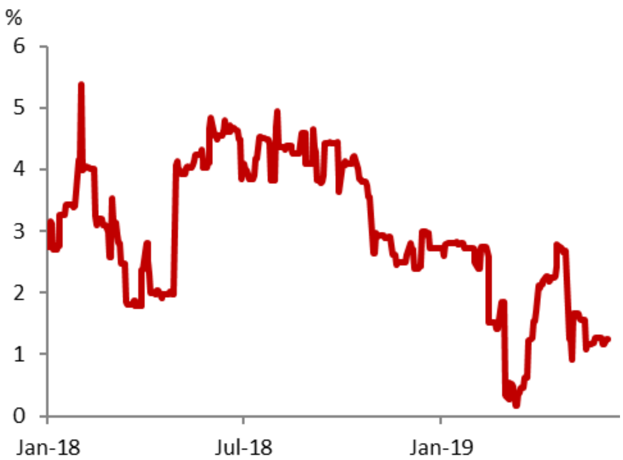
From the US Federal Reserve's perspective, it will become progressively difficult to ignore the market dynamics and pipeline economic risks, in our view. **We are therefore now calling for 25bps rate cuts in September and December of this year**.

The outlook for 2020 is exceptionally cloudy, as some sort of a resolution in China-US tensions could boost sentiments on one hand, whereas rising pass-through from higher tariffs could create a stagflation-type scenario on the other hand, constraining Fed policy. Considering this, we are leaving our call for no further changes in policy rates in 2020 unchanged.

Will the rate cuts accomplish much? We doubt it; the risks to economic slowdown is not coming from high cost of capital. Moreover, there is no link between tariffs and monetary policy. Furthermore, given the considerable rise in public and corporate debt burden over the past decade in the US, a tad lower interest rate payment won't act as a catalyst to pile on more leverage, in our view.

The Fed's motivation to cut rates would stem from the need to be seen doing something, and the notion that lowering real rates would help soothe the credit channel at a time if heightened risk aversion. That the policy rate cut could come in less than three months from now also implies that Fed policy would not be pursued in response to data releases, which may well remain broadly fine for the US in the near term. A hint or two on growing inventories, further unrest in global financial markets, and a worsening of inflation expectations would be sufficient, in our view.

US GDP Forecast (Atlanta Fed)



Source: Bloomberg

Rates: Shallow Fed cut cycle ahead

We have revised our USD, SGD and HKD rates forecasts lower, reflecting two Fed cuts by the end of 2019. If the Fed delivers, this would be one of the fastest about turn in history (keeping in mind that the Fed last hiked in December) as global growth worries and the prospect of protracted China-US friction weigh. The USD interest rates space has clearly been ahead of the curve over the past three quarters. 10Y yields peaked at 3.24% in November, recognizing that further hikes were probably not warranted. More recently, the curve bull-steepened (2Y/10Y) as market participants aggressively start to factor in Fed cuts. Almost four cuts are priced into the Fed funds market within a year, reflecting expectations of slowing growth and heightened uncertainties on the US's trade policies.

Interest rate forecasts		end-2019	end-2020
US	3m Libor	2.10	2.10
	2Y	2.10	2.20
	10Y	2.20	2.50
	10Y-2Y	10	30
Singapore	3m Sibor	1.60	1.60
	2Y	1.80	1.90
	10Y	2.00	2.25
	10Y-2Y	20	35
Hong Kong	3m Hibor	1.80	1.80
	2Y	1.75	1.80
	10Y	1.90	2.20
	10Y-2Y	15	40

*% pa, bps

While we recognize that global growth worries are dominant, we should keep in mind that the yield declines have been sharp. As 10Y US yields hover just above 2% and 10Y German yields start to get sticky at -0.2%, we think it might be time to be more cautious about duration risks. We think that 2-2.5% would be where 10Y US yields would be trading for the coming quarters. Yields could head into the 1.5-2.0% range if the global economic outlook deteriorates further but we reckon that valuations would be too stretched. In 2016 and 2013, a rapid re-repricing of inflation expectations led to a Treasuries' selloff.

Asia rates / govvies should benefit in the medium term. As lower for longer becomes the theme in the developed market space, investors will look to Asia for yield. By some metrics, Asia govvies are attractive, offering high real yields. Policy settings are also tilted towards easing. India, Malaysia and the Philippines have already started cutting rates. We think it could be a matter of time before other economies join in. In the immediate term, risk appetite is critical to watch. Fed cut cycles are typically taken during times of risk aversion. This could lead to period of underperformance in Asia govvies before yields head meaningfully lower.

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