Economics & Strategy

DBS Flash

Fed policy and melt-up risks

Economics/Strategy/Rates/FX

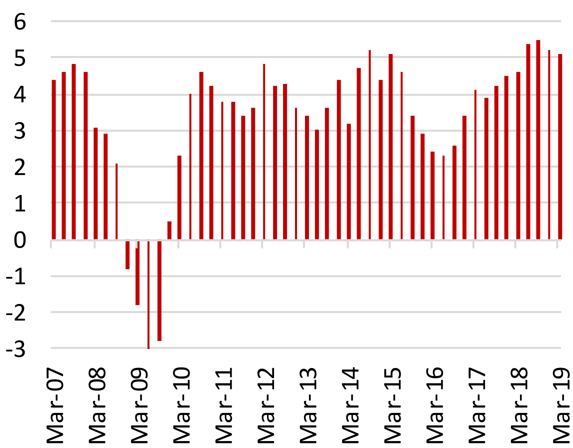
Group Research

July 11, 2019

Taimur Baig, Chief Economist

Please direct distribution queries to Violet Lee

+65 68785281 violetleeyh@dbs.com



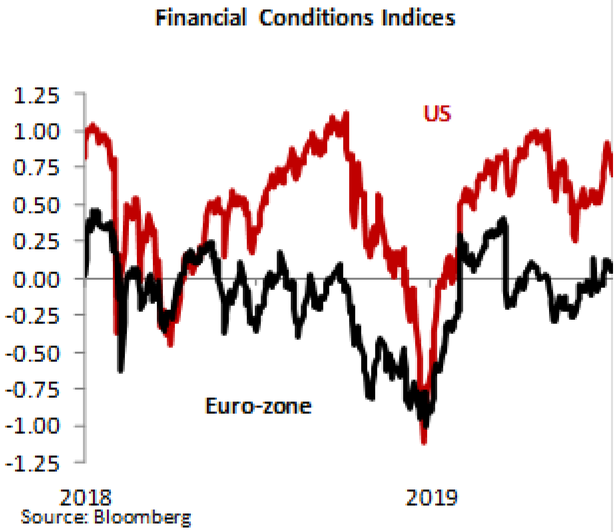
Source: Bloomberg, DBS

- *Markets are getting what they have demanded; ultra-dovish "insurance-taking" stance from central banks at a time when financial and economic conditions are not particularly weak*
- *This will open up melt-up risks, in our view*
- *The intersection of high debt and high valuation will widen*
- *Insurance cuts now will limit room to deal with real shocks later*
- *Expect increasing episodes of market tantrum as the Fed put is played out*

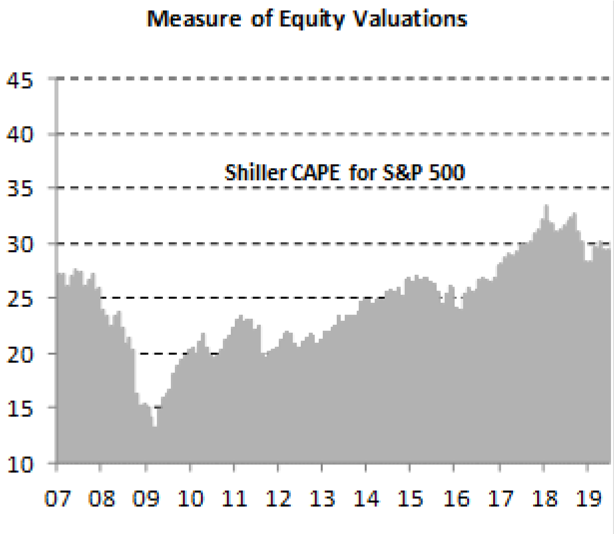
Fed policy and melt-up risks

Federal Reserve Chairman Jay Powell May be secure in his job by constitutional mandate, he nevertheless seems to be doing the bidding for US president Trump. In Congressional testimony (for the semi-annual monetary policy report) overnight, the head of the US central bank could only point to general and tangential risks to the global outlook to make the case for rate cuts. Absent were any concern on financial instability, unemployment, deflation, wages, or fiscal tightening. Indeed, financial markets are at record highs, unemployment at record low, inflation may be below target but nominal GDP growth is near the highest in the cycle, businesses and consumer confidence markers, despite the gloom from trade wars, are only modestly dented.

Against this background, the Fed is reaching for insurance as a hedge toward a weakening global outlook, and the markets are welcoming it. Our concern is two-fold. First, with markets at such heights, and yields already so low, an across-the-board asset price melt-up is a distinct possibility. This will make (if it already hasn't), differentiation between good and bad companies difficult, leading to likely mispricing of risk and misallocation of resources. At a time when debt stocks are already at record highs, and asset validation has spiked, financial fragility will build up inevitably.



It is not particularly difficult to see the seeds of fragility. Further weakening of the Chinese economy will lead to a powerful waning of demand for exporters of commodities and manufactured goods. Various business plans and asset allocation decisions that were based around continued strength of Chinese demand will therefore be challenged. Cyclical slowdown in auto and electronics demand will weigh in on the outlook, independent of Fed policy.



But the rationale for insurance cuts at this immediate juncture is questionable, in our view. The cushion against above risks can be offered by the Fed only if money market conditions tighten or risk aversion spikes. That is absolutely not the case presently worldwide. Also, as the cycle matures and a slowdown appears over the horizon, the Fed needs to keep ample powder in stock to act vigorously when real risks appear. Insurance rate cuts will reduce that stock prematurely.

Perhaps the 2020 US elections are a critical subplot. If easing has to be done, do it the year before elections and stay on the side-line, hoping the insurance cuts to extend the cycle. Such considerations are bound to lead to further complexities and distortions, in our view. Stimulated by the Powell put, the markets will incessantly demand more support after the 2019 rate cuts, in a repeat of tantrums seen in 2015 and 2018. As the Fed's hand is forced time and again, valuations will get loftier, creating the ground for more volatility and event risks. Watch out.

Group Research

Economics & Strategy

Taimur Baig, Ph.D.
Chief Economist - G3 & Asia
+65 6878-9548 taimurbaig@dbs.com

Nathan Chow
Strategist - China & Hong Kong
+852 3668-5693 nathanchow@dbs.com

Ma Tieying
Economist - Japan, South Korea, & Taiwan
+65 6878-2408 matieying@dbs.com

Masyita Crystallin, Ph.D.
Economist – Indonesia & Philippines
+62 21 2988-4003 masyita@dbs.com

Radhika Rao
Economist – Eurozone, India & Thailand
+65 6878-5282 radhikarao@dbs.com

Joanne Goh
Regional equity strategist
+65 6878-5233 joannegohsc@dbs.com

Irvin Seah
Economist - Singapore, Malaysia, & Vietnam
+65 6878-6727 irvinseah@dbs.com

Eugene Leow
Rates Strategist - G3 & Asia
+65 6878-2842 eugeneleow@dbs.com

Duncan Tan
FX & Rates Strategist - ASEAN
+65 6878-2140 duncantan@dbs.com

Chris Leung
Economist - China & Hong Kong
+852 3668-5694 chrisleung@dbs.com

Samuel Tse
Economist - China & Hong Kong
+852 3668-5694 samueltse@dbs.com

Philip Wee
FX Strategist - G3 & Asia
+65 6878-4033 philipwee@dbs.com

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