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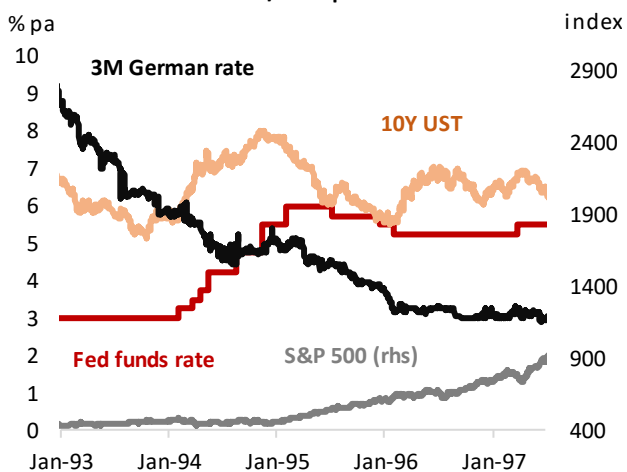


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### Summary and implication for investors

As the Fed gets ready to deliver a couple of “insurance cuts”, we outline how the market would play out. Fed Chair Powell has opened the door to rate cuts, preempting downside risks, in a bid to extend the current expansion. To be sure, fundamentals do not justify Fed easing. CPI prints are supported, the labour market is firm, and retail sales numbers have been resilient.

Fed insurance cuts: the 95/96 experience



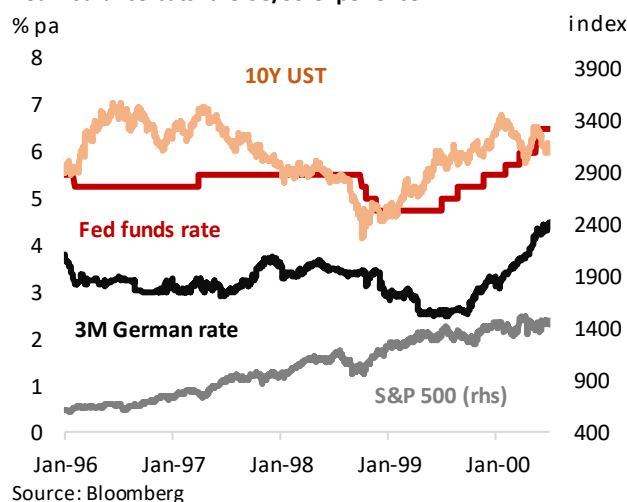
Two past instances from the 1990s (95/96 and 98/99) provide guidance on how things would play out. “Insurance cuts” should not amount to more than two or three. In both cases, the Fed cut by a cumulative 75bps within a short span of time. This was judged to be sufficient to stabilise the US economy.

These “insurance cuts” did not evolve into recession cuts. It is probably easier to interpret that looser monetary policy was enough to maintain US economic momentum.

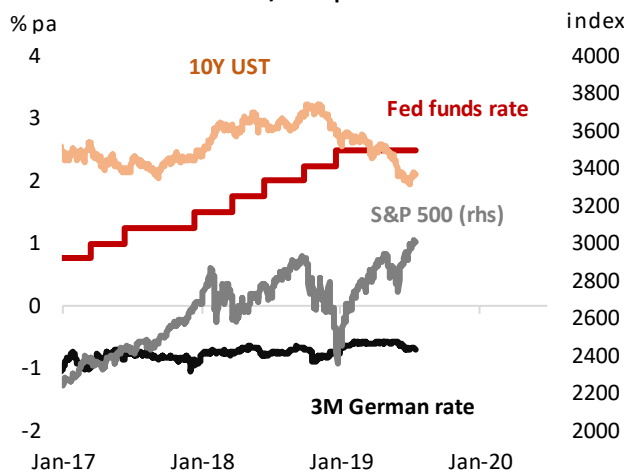
Given widespread perception of the “Powell Put,” we think the US stock market will determine the magnitude of rate cuts. Tightening financial conditions (from falling stock prices) would prompt the Fed to react with more urgency. Stock prices have been remarkably resilient thus far, suggesting that the easing cycle may be shallow.

On the rates side, longer-term US Treasury yields start to bottom as the Fed starts to cut. In

Fed insurance cuts: the 98/99 experience



## Fed insurance cuts: the 19/20 experience?



Source: Bloomberg

1995/96, the trough in 10Y yields formed when the Fed cut for the third time. In 1998/99, the low was hit after the first cut. Rate cuts amidst resilient data should lift inflation expectations and nudge longer-term yields higher.

Fed cuts tend to steepen the UST curve. In this regard, there is no difference between “insurance cuts” versus “recession cuts.” Unless inflation or growth expectations become unhinged, there is no reason for longer-term USD rates to head down by the same magnitude. Instead, looser policy in the immediate term implies higher inflation expectations (and therefore higher rates) over the longer term.

Looking at past data, it appears that the global economy has a say on the shape of the UST curve. We use 3M German rates to proxy the state of the European economy and the broad monetary policy stance in the 1990s. In 1995/96, the 3M German rate was falling. That seemed to have a dampening impact on US yield increases. The picture was mixed for 1998/99 with the 3M German rate rising towards the end of 1999. Currently, likely loose European Central Bank (ECB) policies will cap a lid on how high UST yields can go.

Investors should watch for signs of fiscal loosening in the Eurozone (especially Germany). This could be a gamechanger. Aside from increasing the supply of government bonds, the growth outlook should also improve. Aggressive fiscal policy may be the trigger for the next round of govvie tantrums.

## Implications for investors:

**#1 US Treasuries are trading too rich for “insurance cuts.”** With the market already factoring in 4 cuts over the coming few quarters, it does not make sense to chase yields lower. EM yields are much more attractive.

**#2 Lower for longer EUR rates will cap upside in longer-term USD rates.** This has to be balanced against steepening risks rising from Fed cuts. In any case, longer term yields may bottom as the Fed embarks on easing. **There may be better entry levels to establish UST longs.**

**#3 The U-turn in Fed and European Central Bank (ECB) monetary policy will provide a benign backdrop for EM/Asia rates.** Govvies in the DM world are already expensive, with USD 13tn worth of bonds in negative-yielding territory. Yields are much higher in the EM / Asia space and investors will continue gravitating there.

**#4 There is still room for a further rally in the high yielders (Indo and India).** The rate cut cycles for the two economies are not done and we have a marginal preference for the intermediate tenors (2Y-5Y).

**#5 China govies are attractive, with the 10Y tenor offering a 113bps premium over US Treasuries.** Calibrated easing is still likely in the coming quarters to provide support for the economy.

**#6 Look for yield pickups on a hedged basis.** Govvies with inverted bond-swap spreads and / or favorable cross currency basis swaps include **KTBs, SGSs and Thai government bonds.**

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

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