Economics & Strategy

DBS Flash

FOMC yields to markets; will yield again

Economics/Strategy/Rates/FX

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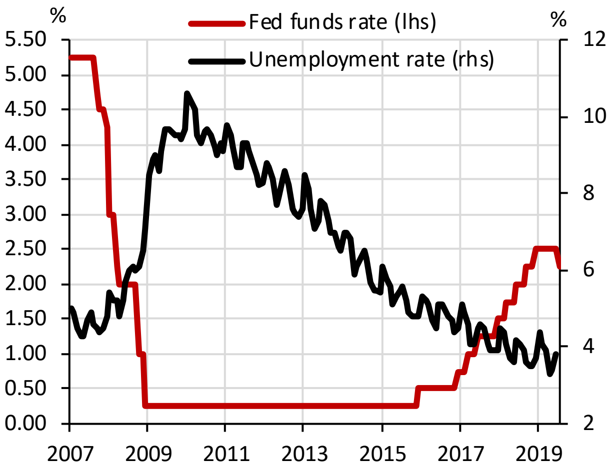
Fed funds rate vs. Unemployment rate



Source: CEIC, DBS. 3Q 2019 data for the month of July

- *Notwithstanding the knee-jerk market reaction of a "hawkish cut," the FOMC has left room for further policy cuts this year*
- *By cutting rates at a time of record high employment, frothy asset markets, rebounding consumer sentiment and housing, the Fed has pushed itself into a corner, in our view*
- *We think that all that's needed for another Fed funds rate cut is no resolution in trade wars and listless asset markets*
- *Of course, this would require poor market performance in the coming months*
- ***Implication for forecast**: The tussle between strong data and poor market sentiment would take a few months. Next rate cut will come in December, in our view. We expect no further rate cuts in 2020, given the proximity to elections, likely trade war truce, and possible firming up of inflation*
- ***Implication for rates**: We don't see curve steepening ahead, unless inflation were to rebound in the coming months. Fiscal slippage and strong growth would be insufficient for inflation expectations to rise, under present circumstances*
- ***Implication for FX**: The USD will remain well supported among weak outlook for China and Europe*

FOMC easing not enough for markets

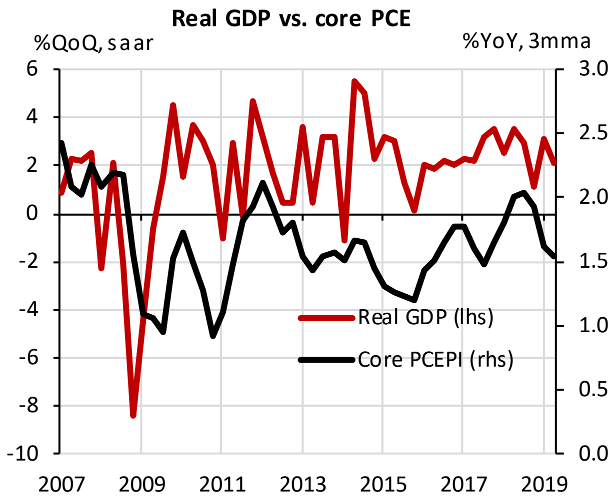
From rate hike in December 2018 to rate cut in July 2019, the US Federal Reserve has undergone a remarkable about-turn. After the conclusion of the July 30-31 FOMC meeting, the policy statement and Chair Powell's press conference suggested the following:

- Global economic weakness (China and Europe) and soft, below-target inflation (core PCE at 1.6%) warrant a "mid-cycle adjustment" rate cut, which downplays the likely magnitude and duration of the rate cut cycle

- Recognising that a further dovish signal is needed, the FOMC decided to conclude the reduction of its aggregate securities holdings (so-called "balance sheet runoff) in August, two months earlier than previously indicated.

- By stating that it is ready to "act as appropriate to sustain the expansion," the FOMC has left room open for further rate cuts, but the focus on the strength of labour market, retail sales, and overall resiliency of the economy means there is no hurry to cut rates.

- Two Fed members voting against the rate cut, and Chair Powell's assertion that this is not a protracted cycle were clearly contrary to market expectations, although we found both such aspects of today's meeting rather reasonable.



Source: CEIC, DBS

We have stated for long that the Fed's dovish tilt can lead to unintended consequences by creating a strong feedback-loop between the markets and the US central bank. By cutting rates at a time of record high employment, frothy asset markets, rebounding consumer sentiment and housing, the Fed has pushed itself into a corner, in our view.

In fact, the markets need not fret much. All that's needed for another Fed funds rate cut is no resolution in trade wars (quite likely) and listless asset markets for a few months, in our view. Given that the US equity market has rallied by 19% this year (even after the July 31 selloff), a catalyst-starved market that is flat or weak ahead is quite likely, in our view.

The tussle between strong data and poor market sentiment would take a few months. The next rate cut will come in December, in our view. We expect no further rate cuts in 2020, given the proximity to elections, likely trade war truce, and possible firming up of inflation. We will however concede that the outlook is shrouded in uncertainty, and what happens in 2020 is hard to pin down just yet.

We don't see appreciable curve steepening ahead, unless inflation were to rebound in the coming months. Fiscal slippage and strong growth would be insufficient for inflation expectations to rise, under present circumstances. The long end of the curve will remain supported given the paucity of safe, positive yielding bonds in the G3 space.

The USD will remain strong among weak outlook for China and Europe and substantial yield differential in favour of the US. Even if the US treasury engaged in intervention, there is little near-term downside for the dollar, in our view.

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