Economics & Strategy Weekly

Weekly: Easing Race

Economics/Strategy/Rates/FX/Equities

DBS Group Research

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- *FOMC cuts policy rate and ends balance sheet runoff*
- *ECB is likely to follow soon with deeper negative rates and likely additional quantitative easing measures*
- *BOJ has indicated that it will not hesitate to add more stimulus if economic momentum softens*
- *Global markets are therefore poised to receive additional liquidity*
- *Global economic and financial markets dynamic will continue to favour the US in the coming quarters, in our view*
- *This is likely to benefit the US dollar, but not without volatility*

Back to policy easing

This week's decision by the US Federal Reserve's Open Market Committee to cut the policy rate and end balance sheet runoff two months earlier than envisaged is just the first of several easing measures by major global central banks. Given the signals provided by outgoing President Draghi, the European Central Bank is likely to follow soon with deeper negative rates and additional quantitative easing measures in the coming months. Also, in its latest policy meeting, the Bank of Japan indicated that it will not hesitate to add more stimulus if economic momentum softens

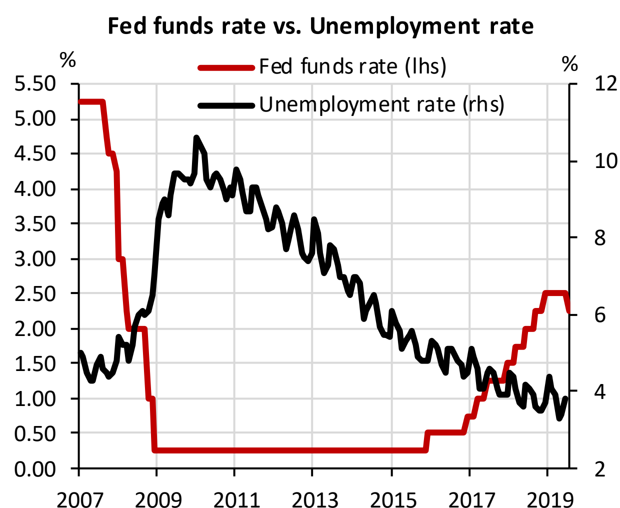
We have therefore reached a transition phase; after a few years of policy normalisation and quantitative tightening, global markets are now poised to receive additional liquidity.

There are two likely ramifications of this shift in stance. First, although economic momentum is faltering in China, Europe, and elsewhere, and trade uncertainties are likely to remain heightened, lower rates and additional QE will support risk assets a tad longer, and possibly extend the economic cycle past 2020. Second, although yield differentials are substantial, the additional liquidity may draw attention back to the USD trend.

One Fed rate cut 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 the FOMC meeting outcome rather reasonable.

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

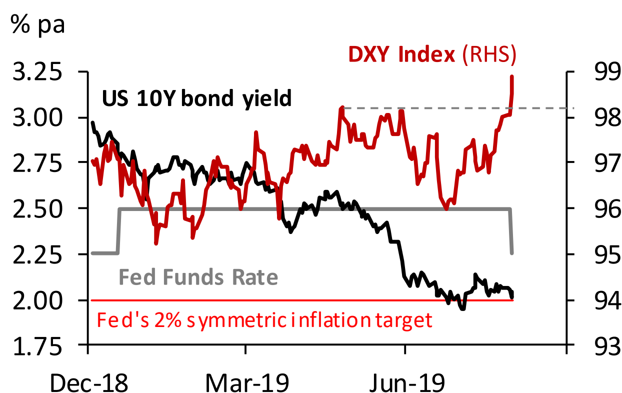
Taimur Baig

FX: Can't keep the USD down

The US dollar is a de facto strong currency on monetary policy divergences. The Fed has labelled its rate cut on July 31 as a mid-cycle adjustment. Effectively, this has pushed back market expectations for a recession-style rate cut cycle. Other central banks have or are moving towards more dovish monetary policy stances. US President Donald Trump has ruled out intervention to weaken the greenback. US Treasury Secretary Steve Mnuchin reaffirmed America's interest in maintaining the greenback as the world's reserve currency. Mnuchin sees a strong USD reflected the strength of the US economy and equities from Trump's policies.

Implication: DXY is eyeing the psychological 100 level with less inhibition

US dollar index (DXY) hit a a new year's high on the Fed's mid-cycle rate cut

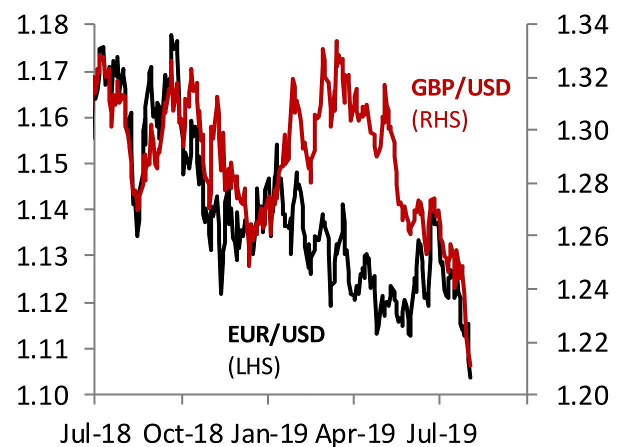


Sources: DBS Research, Bloomberg data

The British pound will remain the weakest currency in Developed Markets. There is less complacency than before about a no-deal Brexit on October 31 under Prime Minister Boris Johnson and his cabinet of hard Brexiters. UK recession risks are notably higher today compared to the post-Brexit referendum landscape in 2016. The gilt market, where the 2Y (0.45%) and 10Y (0.59%) yields have fallen below the policy rate (0.75%), is clamouring for the Bank of England to abandon its rate hike bias in favour of cuts.

Implication: A lower 1.15-1.20 range for GBPUSD is no longer unrealistic

EUR and GBP are dragging each other lower



Sources: DBS Research, Bloomberg data

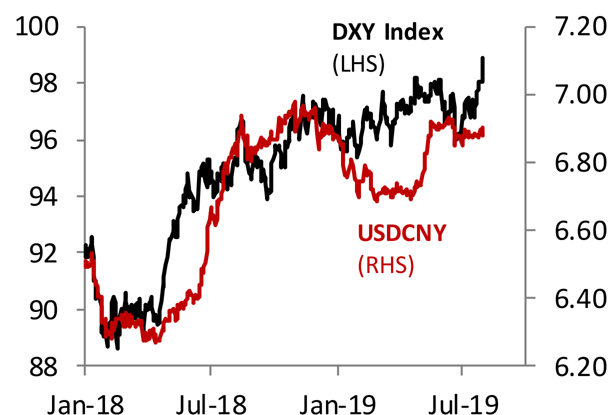
The Euro cannot break free of Eurozone's weak fundamentals. Recession fears have increased for Germany, the largest EU economy. French President Macron's tax cut did not help his economy; growth slowed to 0.2% QoQ in 2Q19 from 0.3% in the previous quarter instead. European Central Bank (ECB) President Mario Draghi is set to lower rates in September before his term ends in October. His successor, former IMF Managing Director Christine Lagarde, is expected to consider resuming asset purchases.

Implication: EURUSD to move into a lower 1.05-1.10 range

The Chinese yuan is set to test 7 again. Without a China-US trade deal, China slowdown worries have not gone away. GDP growth has decelerated to a 27-year low of 6.2% YoY in 2Q19, closer towards the floor of this year's

official 6-6.5% target range. China-US trade talks have restarted in Shanghai on mutual criticisms and will resume in Washington in early September. Renewed USD strength could push USDCNY push out of its 6.85-6.90 range towards 7 again. In the offshore market, USDCNH and the 1Y NDF outright have already risen above 6.90 and 6.95 respectively. They are likely to stay firm after Trump's surprise announcement to hit a 10% tariff on the remainder USD300bn of Chinese imports starting September 1.

It will be challenging for CNY to stay stable in a stronger USD environment



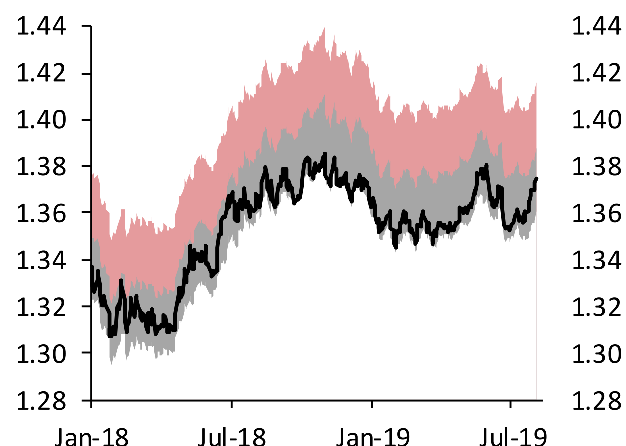
Sources: DBS Research, Bloomberg data

Implication: The prospect for USDCNY to rise above 7 cannot be totally discounted

The Singapore dollar has started to weaken on a trade-weighted basis. We expect the Monetary Authority of Singapore (MAS) to slightly flatten the slope of its SGD nominal effective exchange rate (NEER) policy band at its policy review October. The government will be looking to downgrade this year's 1.5-2.5% growth target; real GDP growth averaged 0.6% YoY in 1H19. CPI and core inflation have eased towards the floors of their official forecast ranges.

Externally, renewed USD strength has lifted our trade-weighted policy band for USDSGD to 1.3610-1.4160 from 1.3500-1.4050 a month ago.

DBS trade-weighted USDSGD policy band



Sources: DBS Research, Bloomberg data

Implication: The scope for USDSGD to hit 1.40 cannot be totally dismissed

Philip Wee

Equities: Fed delivers but uncertainties linger

Asian markets had anticipated the rate cut but are uncertain on how the dollar and bond yields would react. Besides, other than the Fed meeting, there are also numerous ongoing worries, such as the earnings reporting season which is currently in full force, the progress made on trade talks, and within Asia, the ongoing protests in Hong Kong. The impact of the rate cut on different sectors also varies.

Importantly for Asia markets, the dollar has strengthened post the rate cut. US dollar strengthening is generally negative for Asian markets, and it pays to keep watch whether the CNY would be fixed lower as progress stalls on the US-China trade talks. Compared to last year when rate hikes and CNY devaluation weakened Asian currencies, investors are hoping for a reversal in USD strength as a result of rate cuts which could give currencies some breathing space and hence enhance equity returns in USD terms. In our view, they are disappointed on that front as the USD has strengthened further following the rate cut.

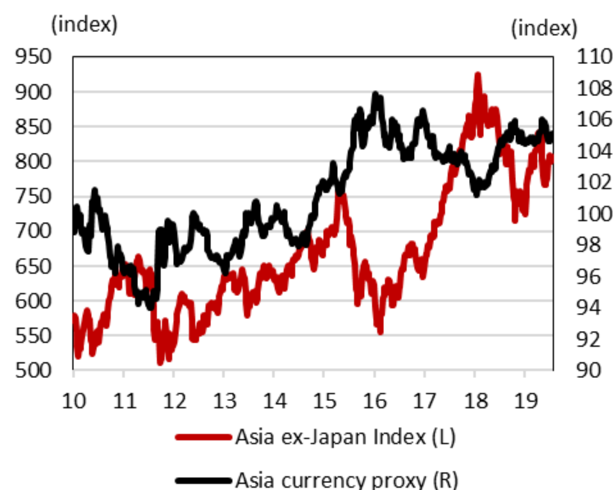
Most Asian central banks have delivered their rate cuts in the past month. And because policy rates in most countries are already low, markets are unlikely to place easing bets, except for Indonesia, Philippines and India. The rate cut cycle in these countries may have to pause until the Fed's next move, which we believe it to be in December.

Asia sectors are also reacting differently to rate cuts. Banks are generally perceived to be losers when rates come down as interest margins may get compressed. A "hawkish" Fed may not be that bad for the banks after all.

The reaction of US bond yields has been muted despite the re-pricing to reflect fewer rate cuts. Lower-for-longer bond yields will continue to enhance the attractiveness of high-yielding sectors such as the REITs.

Fed's "insurance" cut reflects that this is not the end of the growth story while the end of quantitative tightening means easing liquidity ahead. We believe there are still selected opportunities in Asia in this challenging environment, especially those sectors which are less export-oriented and can benefit from lower interest rates.

Asia equities and Asia currencies are inversely correlated



Source: Thomson Reuters, DBS

Joanne Goh

Rates: Trade war drives US yields lower

News that the US will impose 10% tariffs on an additional USD 300bn worth of Chinese imports in September overrode the hawkish signals provided by the Fed. To put things in context, the Fed delivered the widely expected 25bps cut but suggested that an extended easing cycle is not on the cuts. With economic fundamentals still firm, there may not be any need to deliver much beyond a cumulative 50-75bps worth of insurance cuts. Bets on aggressive easing would logically have to be pared, driving short-term USD rates higher.

However, the re-escalation of trade war is taking centre stage, driving a fresh round of risk aversion. 10Y US yields nudged a new low for the year, breaching below 1.90%. Bets on Fed easing also rose, with the market looking at another 4 cuts over the coming year

Our view for lower for longer stays but we have perhaps underestimated how low US yields can go in the coming few months. As noted previously (see Macro Strategy, 1st August), there are multiple factors, including impending asset purchases from the European Central Bank (ECB), that are (and will continue to be) supportive of longer-term US Treasuries. The re-escalation of the trade war will be another key factor dragging yields. As uncertainties mount in a slow growth environment, developed market central banks will inevitably ease policy. Bets on more aggressive ECB easing has surged, with the market pricing in an additional 40bps of easing over the coming year.

Eugene Leow

Highlights of the week

- *Understanding China: Uneven impact of trade war on provinces*
- *FOMC yields to markets; will yield again*
- *Thailand: Policymakers uncomfortable with baht strength*
- *Chart of the Week: Who's benefited from the near-term diversion in US purchases?*
- *Economics and Strategy Monthly: Four ways Asian growth can bottom in 2H19*

Key Forecasts

	GDP growth, % YoY				CPI inflation, % YoY, ave			
	2017	2018	2019f	2020f	2017	2018	2019f	2020f
China	6.9	6.6	6.2	6.0	1.6	2.1	2.3	2.3
Hong Kong	3.8	3.3	2.5	2.0	1.5	2.5	2.7	2.5
India*	8.2	7.2	6.8	6.8	4.5	3.6	3.4	3.6
Indonesia	5.1	5.2	5.2	5.1	3.8	3.2	3.2	3.4
Malaysia	5.9	4.7	4.5	4.2	3.8	1.0	0.9	1.6
Philippines**	6.7	6.2	6.1	6.1	2.9	5.2	3.1	3.1
Singapore	3.9	3.2	0.7	1.8	0.6	0.4	1.1	1.5
South Korea	3.1	2.7	2.1	2.4	1.9	1.5	0.5	1.5
Taiwan	3.1	2.6	1.9	1.8	0.6	1.3	0.7	1.0
Thailand	3.3	4.1	3.4	3.5	0.7	1.1	1.0	1.3
Vietnam	6.8	7.1	6.6	6.3	3.5	3.5	3.8	3.4
Eurozone	2.5	1.9	1.2	1.5	1.5	1.8	1.2	1.3
Japan	1.9	0.7	0.7	0.5	0.5	1.0	1.1	1.6
United States***	2.3	2.9	2.5	1.5	2.1	2.4	1.7	1.6

* refers to year ending March ** new CPI series *** eop for CPI inflation

Policy interest rates, eop

	1Q19	2Q19	3Q19	4Q19	1Q20	2Q20	3Q20	4Q20
China*	4.35	4.35	4.35	4.35	4.35	4.35	4.35	4.35
India	6.25	5.75	5.50	5.25	5.25	5.25	5.25	5.25
Indonesia	6.00	6.00	5.75	5.75	5.75	5.50	5.50	5.25
Malaysia	3.25	3.00	3.00	2.75	2.75	2.75	2.75	2.75
Philippines	4.75	4.50	4.25	4.25	4.25	4.25	4.25	4.25
Singapore**	1.95	1.95	1.80	1.60	1.60	1.60	1.60	1.60
South Korea	1.75	1.75	1.50	1.25	1.25	1.25	1.25	1.25
Taiwan	1.38	1.38	1.38	1.38	1.38	1.38	1.38	1.38
Thailand	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75
Vietnam***	6.25	6.25	6.25	6.25	6.00	5.75	5.75	5.75
Eurozone	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Japan	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10
United States	2.50	2.50	2.25	2.00	2.00	2.00	2.00	2.00

* 1-yr lending rate; ** 3M SOR ; *** prime rate

Exchange rates, eop

	Q1 19	Q2 19	Q3 19	Q4 19	Q1 20	Q2 20	Q3 20	Q4 20
USD/CNY	6.71	6.87	7.00	6.95	6.90	6.85	6.80	6.75
USD/HKD	7.85	7.81	7.85	7.84	7.83	7.82	7.81	7.80
USD/INR	69.2	69.0	71.0	71.5	71.0	70.5	70.0	69.5
USD/IDR	14243	14126	14500	14400	14300	14200	14100	14000
USD/MYR	4.08	4.13	4.25	4.23	4.21	4.19	4.17	4.15
USD/PHP	52.6	51.3	55.0	54.5	54.0	53.5	53.0	52.5
USD/SGD	1.36	1.35	1.40	1.39	1.38	1.37	1.36	1.35
USD/KRW	1135	1155	1180	1170	1165	1160	1155	1150
USD/THB	31.7	31.0	33.0	32.8	32.6	32.4	32.2	32.0
USD/VND	23189	23301	23500	23450	23400	23350	23300	23250
AUD/USD	0.71	0.70	0.64	0.66	0.68	0.70	0.72	0.74
EUR/USD	1.12	1.14	1.08	1.09	1.10	1.11	1.12	1.13
USD/JPY	111	108	112	111	110	109	108	107
GBP/USD	1.30	1.27	1.22	1.24	1.26	1.28	1.30	1.32

Australia, Eurozone and United Kingdom are direct quotes

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