DBS Flash

US: A marginally dovish hike

DBS Group Research

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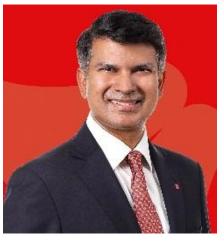

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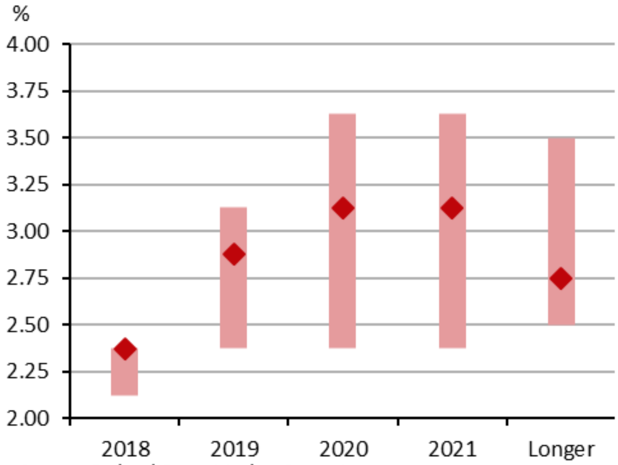
- *Faced with asset market selloff and worsening sentiments, the US FOMC carried out a dovish hike in its last meeting of the year*
- *Dot plots now suggest two hikes next year; we will not fight the Fed and adjust our expectations accordingly.*
- *Markets may want an even more dovish Fed, but given the closing of the output gap, exceptionally low unemployment rate, high levels of vacancy, 3% wage growth, and still-strong business sentiments, that is unlikely to transpire in the first half of 2019*
- *News headlines may be dominated by doom and gloom, but there are three likely catalysts for a positive start to next year: low oil, China stimulus, and easing of trade tensions.*

Fed ends the year of four policy rate hikes; at least two more to come next year

Market participants have been on the edge leading into the last policy meeting of the US FOMC, with the VIX spiking to over 25 this week (first time since early February 2018). In the event, the Fed sounded only marginally more cautious, with its members guiding expectations of two further policy rate hikes next year on top of the 25bps hike from today. This may not please the markets, but we find today's decision and the guidance quite reasonable.

Fed Dot Plot - Median and Range



Source: Federal Open Market Committee

We have been calling for four rate hikes next year, but in light of ongoing developments and today's Fed decision, will adjust our call to two hikes next year (in June and September). Fed governors are seeing the scope to hike one more time in 2020, which might be wishful thinking. In a year's time, the conversation will likely be possible rate cuts in 2020, in our view. For now, we will refrain from prognosticating about 2020, and focus on the next four quarters.

Curves have flattened considerably lately, but neither the Fed nor we see this warranting major concern. US output gap has closed, job vacancies are at record high, wages are growing by 3%+, and growth markers show solid 2.5%+ momentum.

Admittedly, core PCE inflation has surprised on the downside lately (thus giving the Fed the room to pause in the near term), housing and auto sales have been somewhat disappointing, and any hope for further fiscal support in the coming years have dissipated. But at the same time, the US fiscal deficit has soared with no resolution in sight, the outlook for oil is highly uncertain given lingering tension in the Middle-East, and structural liquidity is tightening with the end of QE in Europe. Further curve flattening may be on the cards, but not a whole lot more, in our view.

What about the dollar? We expect less support for the greenback in 2019, but we still see a flat trajectory over an outright correction. Growing worries about the US notwithstanding, neither growth/policy nor the political outlook of EU or Japan warrant a shift of assets there. We therefore expect the flow of funds to keep the USD stable in the coming year. The dollar will eventually correct, but that phase in not near at all.

Our worries about developed market equities and credit will remain. Valuations are still high despite the recent selloff, leverage is elevated, and sentiments are on the weak side. The Fed may be pleased with the economic trends, but clearly the market had bet on a much stronger outcome for late-2018 and 2019. Between trade wars and China slowdown, that bet is bound for disappointment.

This in turn makes Asia relatively more compelling. Any easing of tension in trade wars, low oil, and further policy stimulus from China will cheer local markets next year, in our view. We are picking up a rise in investor interest in Asia's beaten-down assets. A silver lining indeed.

Taimur Baig

Rates: Late cycle trading

Factoring in a less aggressive Fed for 2019 (two hikes, taking the Fed funds rate ceiling to 3%), we have revised down our USD, SGD and HKD rates accordingly (see table). Turbulence in the financial markets have persisted since October and credit spreads have widened meaningfully. With US economic data still firm, policy normalisation is still in the offing. However, the market will likely focus on the point that we are in the late cycle in the US economic expansion and that policy rates are probably close to the cyclical peak.

Against what is likely to be a volatile backdrop, 2019 is likely to be more of a trading environment as USD rates start to go sideways. In fact, USD rates (10Y and 30Y) may have already peaked in November 2018. With these in mind, we think that flattening trades (2Y/10Y) and going long duration (10Y) may be the best way to navigate the coming quarters. At current levels, these trades are unattractive. However, this is due in large part to a persisted period of risk aversion that kept the VIX above 20 for 30 trading days since October. Longer-term USD rates are therefore driven lower than they otherwise would have been. We suspect that when VIX falls towards 15, 10Y yields could drift towards 3%, which would provide a much more compelling risk-to-reward for duration (and possible flatteners).

Interest rate forecasts		end-2019	end-2020
US	3m Libor	3.20	3.20
	2Y	3.00	2.90
	10Y	3.00	2.90
	10Y-2Y	0	0
Singapore	3m Sibor	2.30	2.30
	2Y	2.20	2.10
	10Y	2.35	2.25
	10Y-2Y	15	15
Hong Kong	3m Hibor	2.70	2.70
	2Y	2.40	2.30
	10Y	2.45	2.35
	10Y-2Y	5	5

*% pa, bps

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