# US asset markets: What Fed cuts mean for US Treasuries and the dollar

G7 Finance Ministers and central bankers hold a conference call on the impact of the coronavirus this Tuesday. We think this could ultimately lead to the Fed cutting rates 100bp through the first half of this year, 10-year US Treasury yields dipping to 0.75% and EUR/USD trading up to 1.15


## A negative print for 2Q20 US GDP and a 100bp Fed easing cycle

The US economy appears to have started 2020 on a strong footing with consumer confidence close to record highs, business surveys bouncing back as trade tensions eased and residential investment a key source of strength. However, it is increasingly apparent that the US faces a significant economic drag relating to the coronavirus. There was already a (relatively modest) supply shock as supply chains faced disruption due to factory closures in China and other parts of Asia, but over the past couple of weeks this has increasingly turned into a financial shock as bond yields and equities plunge. The concern is that the fear factor surrounding Covid-19 will change corporate and consumer behaviour and lead to a demand shock as well. This is most likely through the service sector of the economy with travel, hotel accommodation, restaurants and leisure-related sectors looking vulnerable. A negative second quarter GDP print is a clear possibility.

Fed Chair Powell released a statement Friday afternoon saying the Federal Reserve is “closely monitoring” developments and stands ready to “use our tools and act as appropriate to support the economy”. This clearly hints that the Fed is poised to implement rate cuts at any point – the Fed knew full well that making such a statement would only fuel expectations of action - and we now expect a 50bp rate cut imminently. The next scheduled meeting is 18 March, but given financial market volatility/tensions this could certainly happen much sooner. We doubt it will trigger a meaningful boost to aggregate demand, but implementing rate cuts should help to mitigate some of the strains in the financial system, particularly if it is accompanied by additional liquidity/credit measures. We are also pencilling in two further 25bp rates cuts for 2Q giving a total of 100bp of easing.

## US Treasury Yields: How low can they go?

The US yield curve had been flattening as the bond market front-ran the Fed. That has morphed into re-steepening as the market now discounts a more imminent move from the Fed. That discount is quite pronounced now, with the 2yr at c.75bp. At that level the front end is comfortably discounting 100bp in rate cuts. That said, part of this move on the front end is also the outcome of risk asset players parking some of their liquidated product on the front of the Treasury curve, and in bills. Typically this can see the 2yr overshoot to the downside during times like these.

The 10yr is now homing in on 1%, and in all probability will breach below that level in the coming weeks. There are two routes to consider. One is where the Fed holds off on cutting rates, and there is a flight into bonds which pushes the curve further down. The second is where the Fed gets in early with a cut, averting near-term damage. Here, the 10yr could well back up as equity markets briefly rally. But the subsequent reaction is still likely to be biased towards a re-test lower in equities, along with a push lower in the 10yr yield. We’d view a 50bp 2yr and a 75bp 10yr as entirely conceivable here.

The reaction function further out the credit curve is important too. Fed cuts would likely be accompanied by extra liquidity provision to the banking system, and the re-ignition of some QE would make imminent sense. Banks should be under far less pressure during this crisis than the last one. They have been building liquidity buckets, that have performed as rates have fallen. They are better capitalized. Still vulnerable to a wider slowdown, but not a massive point of concern for the Fed. A bigger concern is the functioning of the wider financial system.

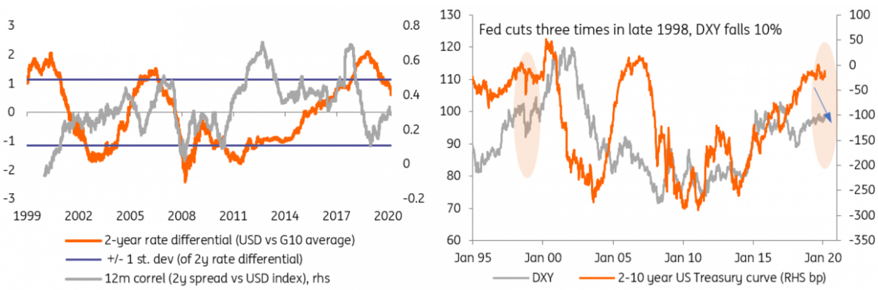
The sell-off last week was as orderly as one could hope for given the size of the fall. That’s good. But another week like that and price discovery could well become more opaque. That would not be good. High yield has been under particular pressure. The focus here is on a likely elevation in default risk. The good news is that investment grade corporates are long cash. They have not been over-investing and have been paying off debt in fact. An associated risk though is a closing of the primary market. Against that backdrop the Fed will be eager to ensure that there is easy access to liquidity for the wider economy.

## US Dollar: A 5-10% correction

The US S&P 500 at one stage last week was off 15% from its mid-February highs. Typically, high beta/high yield currencies are hit most during episodes like this, whilst the dollar enjoys some safe-haven properties on the back of the liquidity and yield advantages. What has changed over the last week is that the market is now convinced – helped in part by the Fed statement late Friday – that the Fed is set to imminently embark on a series of emergency rate cuts.

That flip to bullish steepening from bullish flattening in the US 2-10 year yield curve has seen the dollar fall across the board – even against the low-yielding EUR and JPY. With the ECB and the BoJ far more constrained in what they can deliver in terms of rate cuts, the US yield advantage is therefore narrowed sharply. Over the last couple of years yield differentials have not had much say in dollar pricing – but we have argued that those differentials have been too wide to make a difference. These differentials have now narrowed back inside historical norms (+/- one standard deviations) and should have a bigger say in dollar pricing going forward.

As James notes above, we see scope for the Fed to deliver as much as a 100bp easing cycle over coming months. That should temporarily hit the dollar – just as the 75bp Fed easing cycle interrupted the dollar bull trend in 1998. That cycle was worth a 10% correction in the DXY. So far we've seen a 2.5% correction in DXY from last month's highs. With equities set to stay fragile over coming months, we certainly think DXY can fall another 3% (5% from the highs) from current levels. We therefore seeing EUR/$ correcting to the 1.15 area in 2Q20, before dropping back to 1.10 towards year-end. Equally USD/JPY looks set to press strong support at 105 over coming quarters.




Source: Bloomberg, ING

| | 1Q20 | 2Q20 | 3Q20 | 4Q20 | 1Q21 | 2Q21 | 3Q21 | 4Q21 |
|---|---|---|---|---|---|---|---|---|
| **EUR/USD** | **1.12** | **1.15** | **1.12** | **1.10** | **1.10** | **1.10** | **1.10** | **1.10** |
| Prior* | 1.10 | 1.11 | 1.12 | 1.13 | 1.14 | 1.15 | 1.18 | 1.20 |
| **USD/JPY** | **107.0** | **105.0** | **107.0** | **108.0** | **109.0** | **110.0** | **110.0** | **110.0** |
| Prior* | 108.0 | 108.0 | 108.0 | 108.0 | 107.0 | 106.0 | 105.0 | 100.0 |

Source: Source: ING, Prior: 'Monthly Economic Update: Feb 7th, 2020'

## Authors

**James Knightley**
Chief International Economist
james.knightley@ing.com

**Padhraic Garvey, CFA**
Regional Head of Research, Americas
padhraic.garvey@ing.com

**Chris Turner**
Global Head of Markets and Regional Head of Research for UK & CEE
chris.turner@ing.com

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