Good MornING Asia - 4 March 2020

So much for a demand supporting sentiment boost by the Fed, but maybe the counterfactual would have been worse. And it does put pressure on other central banks to follow suit in some fashion, even if rate cuts are not feasible for all

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10Y US Treasury yields below 1%

An off-cycle cut from the Fed was not a total surprise, but the speed with which the Fed moved, following Jerome Powell's hint last Friday, was quite breathtaking James Knightley has written more about the decision here.

The market response has been interesting, and maybe not quite what had been hoped for. Equity markets (the S&P500) rose initially, but then sold quite heavily, and that is probably likely to be the reaction in Asia's markets today. Asian equity futures look rather mixed right now.

The US Treasury market rallied further, with the yield on the 10Y bond dropping below 1.0% (fractionally), and 2Y Treasury yields fell sharply to under 70bp which has had the knock-on effect of weakening the USD, which against the EUR, now stands at 1.1181, though this is only a small move relative to recent days.

A number of questions are worth asking now folllowing this Fed action.

1. Will markets shrug off this Fed action and resume their sell-off?
2. Will the Fed do nothing further on March 18 (their next scheduled meeting) - James Knightley is indicating a further 50bp of easing in 2Q20, but markets are impatient, and that

seems a long way away, though there is, of course, an argument for conserving firepower, bearing in mind that the US is likely to see the disease worsening over the coming weeks and months.
3. Will the Fed's move spark some additional easing from other central banks around the world - yesterday we had 25bp of cuts each from the Reserve Bank Of Australia and Bank Negara Malaysia.

G-7 statement - some words

Here is part of the G-7 statement of Finance Ministers and Central Bank heads released yesterday. "We reaffirm our commitment to use all appropriate policy tools to achieve strong, sustainable growth and safeguard against downside risks", adding that they are "closely monitoring" Covid-19. Perhaps it was in response to this underwhelming statement, which outlined no specific measures, that the Fed felt compelled to act.

Maybe it is the dawning realisation by markets that this disease and its impacts on the economy are not things that conventional policy tools have much defence against, that has led to the resumption of selling. Overnight, the new case count provides no comfort, with new cases in Europe still rising at a rapid pace, and more countries showing their first cases of Covid-19 (Ukraine, Argentina, Chile, Lichtenstein).

On the calendar today and other stuff

There isn't much of interest on the calendar today apart from the Bank of Canada. The Bank of Canada was already expected to deliver a 25bp cut at this meeting, and so that wouldn't be a surprise. But maybe there is some possibility that they might now follow the fed and deliver a 50bp cut.

Iris Pang has written too on what we may expect from the PBoC in the coming days and weeks "I expect 10 bps cuts in 7D reverse repo, 1Y Medium Lending Facility and 1Y Loan Prime Rate, plus 0.5 percentage points cut of targeted RRR to help Covid-19 affected companies. Repayment due dates are extended for tight cash flow companies, which should be the most effective measures so far."

Author

Robert Carnell
Regional Head of Research, Asia-Pacific
robert.carnell@asia.ing.com

ASEAN Morning Bytes

Fed's emergency rate cut sounds alarm bells instead of allaying fears.

EM Space: Fed "bazooka" cut may spook market players on Wednesday

- **General Asia:** The emergency "bazooka" 50 bps rate cut by Jerome Powell and company failed to lift market sentiment substantially with investors doubting that the daring rate cut could prevent a full-blown US recession as the virus claims more fatalities. Investors will continue to monitor the spread of the virus and China's services PMI data later on Wednesday for additional cues for trading.
- **Malaysia:** January trade figures today will reinforce persistently weak exports. Bank Negara Malaysia cut the policy rate by 25bp to 2.50% yesterday, noting persistent downside risks ahead from a prolonged impact of the Covid-19 and weakness in commodity-related sectors. With inflation running around 1% (barring a January spike to 1.6, which is going to be reversed) BNM has more room than most other Asian central banks to ease further. Taking a cue from the accelerated global easing cycle, we are adding one more 25bp rate cut to our BNM policy forecast for this year, taking the overnight policy rate to an all-time low of 2% reached during the 2008 global financial crisis by July this year.
- **Singapore:** The manufacturing PMI dipped to 48.7 in February from 50.3 in the previous month, the biggest single-month fall in over five years. The electronics sector PMI fell to 47.6 from 50.1. With the risk of an economic recession looming large, we see the MAS joining the global easing bandwagon at the next policy review in April
- **Thailand:** Prime Minister Prayuth Chan-Ocha has announced urgent measures to contain

the Covid-19 spread. He has put Deputy Prime Minister Somkid Jatusripitak and Finance Minister Uttama Savanayana in charge of measures to support the economy, which are likely to range from tax incentives, loan deferments to confidence-boosting measures for capital markets. We also expect the Bank of Thailand to cut the policy rate by 25bp at the next meeting on 25 March.

- **Indonesia:** Indonesia announced that they were readying a second stimulus package to insulate Indonesia from the economic fallout from Covid with Jokowi vowing to more than double up on the initial $750 mn package. The two packages would need to be funded outside the 2020 budget, indicating that they may need to breach once again their deficit-to-GDP target for the year. We expect Indonesia to roll out both fiscal and monetary stimulus to curb the projected slowdown from the virus with more emphasis on fiscal spending given that Bank Indonesia will be hard-pressed to cut further given the recent struggles of the IDR.

What to look out for: Response to Fed cut Covid-19

- China Caixin PMI services (4 March)
- Malaysia trade (4 March)
- Philippines inflation (5 March)
- Thailand inflation (5 March)
- US initial jobless claims (5 March)
- Taiwan inflation (6 March)
- US trade balance and jobs report (6 March)

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A big change from last month

If we look back at last month's on hold decision by the RBA, we see lots of references to the phase one trade deal, positive global outlook, and only an occasional reference to the coronavirus. There are, in fact, far more references to the bushfires.

Admittedly, quite a lot has changed since then, but we're obliged to say that the case for a rate cut was clearly evident a month ago (we were making it then) and today's cut comes across as a little bit late. If that sounds a bit like sour grapes (we did not anticipate the RBA changing its view so abruptly), then it probably is.

We speculate that the groundswell of dovishness coming from other central banks, the Bank of Japan, Federal Reserve, and most recently, the European Central Bank, may have helped to galvanise support within the RBA for moving this month. Later today, the G7 finance ministers and central bank heads meeting will also likely deliver some words of encouragement (though little actual substance we imagine), and that might also have been a tough backdrop against which to leave rates on hold for a second month.

More coming

The latest statement makes far more of the risks to growth and downplays the likelihood of any improvements in Australian wages or GDP, which for the first quarter, is expected to look "noticeably weaker". We would add that if this is the outlook for the first quarter of 2020, then the second quarter will probably look even weaker. Bear in mind that Australia has only 34 cases of Covid-19 so far, so were the disease to spread locally, then on top of supply chain disruptions and weak Chinese demand, we can also expect domestic demand to suffer as well.

To cut a long story short, the outlook for the virus and Australia is more likely to worsen in the near term than improve. As a result, it is virtually impossible now to imagine that we will not see a further 25bps of easing from the RBA at the April meeting. Markets are already largely pricing this in.

What happens after that depends entirely on the spread of the virus, both globally, and in terms of Australia itself. While some are suggesting a positive scenario based on warming weather, remember, that only applies to the Northern Hemisphere. And as we move towards the middle of the year, parts of Australia will get noticeably cooler, and in all likelihood, wetter.

What could unorthodox policy look like in Australia?

In a piece we wrote about a month ago, we took a close look at what unorthodox policy might look like in Australia, without really being convinced that we might be staring at this in the face so quickly. There are a number of problems with trying to impose an ECB-style quantitative easing programme on Australia, not least of which is the relative absence of government debt securities. Likewise, the RBA seems to view negative interest rates as likely to do more harm to domestic demand than good - correctly in our view, for what that is worth.

That doesn't leave a lot of options, though some form of targeted lending, along the lines of the Bank of England's experiment with "funding for lending" (cheap money for banks, contingent on SME lending) might be a possible avenue, as would buying up bank paper to reduce their funding costs.

What does this mean for the AUD?

The reaction of the Australian dollar (mildly higher) after the RBA cut shows how markets had already completely priced in the move by the time of the meeting, and some investors were possibly expecting a deeper cut.

In line with the global dovish repricing, futures on the RBA cash rate show markets broadly expecting another cut at the April meeting (around 75% implied probability). While this may suggest that further downside for AUD looks limited, there is a key caveat. As highlighted above, another cut would inevitably raise the question of unorthodox monetary policy. Unless the RBA clearly excludes this option, markets will likely be tempted to speculate around possible QE, which would inevitably pile pressure on the AUD.

Looking at the shorter-term, a round of global easing and a subdued US dollar may help avert another slump in the AUD/USD for now. However, we have noted above how the coronavirus has only marginally spread within Australian borders so far: this may change quite rapidly (as we learned from other countries), which further convinces us it is still early to call a bottom in AUD just yet.

Authors

Robert Carnell
Regional Head of Research, Asia-Pacific
robert.carnell@asia.ing.com

Francesco Pesole
FX Strategist
francesco.pesole@ing.com