

Markets respond to patient Fed

"No strong arguments for a move either way" clips the US rate-doves' wings, pushing USD higher.



Source: Federal Reserve

2.35%

Interest rate on US Excess Reserves

down 5bp

Lower than expected

Technical changes show how little real liquidity there is

James Knightley has done [his usual thorough job summing up last night's FOMC decision](#). Which can be characterized as highlighting the ongoing (though transitory) lack of inflation, whilst also flagging the better outlook for activity and the balance of risks.

2-Year Treasury notes responded to the cold water poured on rate-cut ideas by falling, with yields rising around 4bp, though it was a hairy ride, and they were at one point down 6bp.

The 10Y yield is almost unchanged at about 2.50%, resulting in a slightly flatter yield curve.

The technical adjustment to the interest rate on excess reserves (IOER) is interesting. With the Fed funds rate trading through the IOER recently, the Fed has acted to push the effective Fed funds

rate back towards the centre of the 2.25-2.5% target range. The IOER was lowered to 2.35% from 2.4% following recent sessions in which the effective Fed funds rate has traded above it. The IOER was designed to act as a type of ceiling to the Fed's target range, but recent price action shows that by paying the banks a decent rate for doing absolutely nothing, the real liquidity in the overnight dollar market is set outside the banking system, by the much smaller liquidity source of the Federal Home Loan Banks, which don't get IOER and so are free to lend.

There is a good piece on Bloomberg today, their Bloomberg Reaction, "Fed tweaks IOER but no Repo Facility Innovation", which discusses the next moves. A Repo tool would make sense. When the Fed first normalized policy, it used a reverse-repo facility to ensure the effective rate would hold the floor of the target-range. Now a repo facility to ensure the ceiling is not breached seems a sensible addition.

USD stronger on Fed decision

The dollar index is stronger following the FOMC decision and testimony, no doubt bolstered by the damage caused to the rate-cut thesis. Two currencies in the Asia-Pacific region to watch are the AUD and NZD. Both have upcoming rate meetings. Both have growing reasons to cut, with poor NZ employment data most recently, and soft Australian inflation.

The AUD is trading just above the 0.70 level. And although I would say that this might be a bit weaker than fundamentals would suggest, in the short term, we still like a foray into the AUDUSD 0.69-something area. The NZD should follow it lower, though which currency weakens most, will probably reflect a horse race between the two central banks to see which can out-do the other with dovishness.

Elsewhere in Asia, the story on FX is a mixed one, some up, some down, some unchanged. This micro-shift in the Fed may take a little thinking about when there are other factors at work, both domestic (rate cut thoughts in some economies) and international (the impact of oil prices weakening - good for INR, not so good for MYR, for example).

Korean inflation - not as bad as feared

After a string of weak reports, Korean inflation for April was not as bad as expected, with the core rate remaining unchanged at 0.9%YoY and headline inflation nosing up to 0.6% from 0.4%. Ignoring historical base effects and focussing only on price levels of subcomponents, the better outcome seems to have been heavily food driven, though there was a small increase in furnishings too as well as transport, which, bolstered by small monthly increases in other components, has helped keep the April figure from sliding further.

That said, the rate of inflation is substantially below the Bank of Korea's (BoK's) target rate of 2.0%. with weak exports and domestic activity. The BoK is resisting calls for a cut, but we suspect it is only a matter of time before they reverse last November's hike with a 25bp cut later this quarter.

Thailand provides stimulus measures

(From Prakash Sakpal): The Thai government announced a THB 13.2bn economic stimulus directed at farmers and low-income people. This follows the downgrade earlier this week of the government's GDP growth forecast for 2019 to 3.8% from 4.0%. At less than 0.1% of GDP, we doubt the package will be enough to shore up growth. The hawkish central bank and persistently

large current account surplus sustain the potential for THB outperformance, though we maintain our view of the USD/THB rate hovering around 32 through 3Q19.

Asia Day ahead - more PMIs, HK GDP, Indon inflation

The rest of the day is a mopping up exercise for those countries in the region that have not yet released manufacturing PMI data, Most of the ASEAN plus Korea. We aren't expecting any surprises or much to celebrate in these figures.

Indonesian inflation could nose slightly higher but remains moderate. And with BI more fixated on the external balance, we don't expect this to change policy settings meaningfully.

And with China on vacation today, HK GDP figures may be our closest thing to a proxy release on the strength of the Chinese economy.

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