

Promises are made to be broken

Markets haven't received the Fed's latest pronouncements too favourably, which is not surprising for a number of reasons that they might have anticipated



I'm going to cut out gin and curry until the New Year

Anyone who knows me would regard a statement like "I'm going to cut out gin and curry until the New Year" as an obvious lie, or at best, a good intention that is likely to last no more than week. And so it is with the Fed's pronouncements overnight to keep rates at least as low as they are now until the end of 2022 ([here's a link to their latest statement](#)).

So, what if the US economy does actually come roaring back? And employment too? I don't think this will happen quickly, and with this, I am totally in line with Jerome Powell that many of the jobs lost as a result of the pandemic will come back slowly if at all. But we both might be wrong. It happens.

If we are both wrong, then Powell has two choices:

1. to muscle it out, and keep rates low even when the data says hike;
2. or do a U-turn and hike

Ignoring a better economy probably isn't the risk it once was, and I very much doubt this would do

more than enable a further positive distortion to risk assets. But a U-turn would damage the Fed's credibility for any forward guidance they attempted to give in the future (but then such promises are pretty empty anyway, as markets seemed to demonstrate last night, as they sold off during the press conference).

As usual, [all the gory details are covered by our Chief International Economist James Knightley, so here is the link to his note on the statement and press conference.](#) I'm going to focus on the market reaction, and the commitment to keep rates no higher than they are today until end 2022 suffers from the same problem as my curry commitment, that it is time-inconsistent.

That means that when circumstances change, for example, if I get hungry, or the US economy grows more than expected, then my incentives will also change, and so will those of the Fed. A more credible, and therefore more effective statement would have been to say that rates will remain no higher than they are today until the unemployment rate has fallen to X%, with X being a number not too far above the US full-employment rate, whatever the Fed claims that to be at the time (it does change). That could happen quicker, or it could happen slower. But the incentives on adhering to such a promise would not change.

In addition, markets might just also be showing how dependent they are on incremental policy easing. Simply remaining ultra-loose may not be enough any more, especially when a V-shaped economic or corporate earnings recovery seems an unrealistic dream. In which case, Jerome Powell may look at the 0.5% drop in the S&P500 yesterday and conclude that it was not a bad day's work. It could certainly have been worse. But it does raise the question of "What if we need to do something more?". That "something" appears at this stage to be yield curve control. The Fed is still keeping its options open on this. It's a reasonably effective policy when coupled with credible economic commitments, as the Reserve Bank of Australia has shown. But from where the Fed sits today, it is a very marginal incremental easing when policy rates are already zero, and bond yields are also very low requiring minimal asset purchases from the Fed.

This isn't quite an [Emperor's New Clothes moment](#), but it isn't far off in my opinion and comes at a time when the US new Covid-19 case numbers are looking a bit more threatening, with notable increases in Arizona, Florida, North Carolina, Texas and Utah. Renewed lockdown feels like an incredibly difficult step for these states to make if the numbers worsen further, which could provide markets with new grounds for concern. As well as some equity weakness, the latest move also showed the USD firming a little, which is consistent with a broader risk-off move. That could threaten to undo some of the big moves we have seen in Asian currencies, particularly the IDR and KRW - Asia's best performing currencies month to date (throw in the AUD and NZD too).

Asian data out and looming

Back in Asia now, and **Japan's** 2Q20 business sentiment indicators have plunged further, offering an insight into the chasm into which GDP in 2Q is likely to fall. The all-industry index dropped from -10.1 to -47.6. That's within a whisker of the 2009 GFC low of -51.3. And the large manufacturing index fell to -52.3, which is also just a shade less bad than the 1Q2009 figure of -66. We are officially forecasting a quarter-on-quarter decline of 7.1% in 2Q20, which translated into a sensible forecast excluding decimal places means anything between -5% and -10%. This is consistent with these latest sentiment indices. No revisions needed.

And elsewhere in Asia, Prakash Sakpal picks up the narrative:

"**Malaysia:** April industrial production (IP) data today will shed light on GDP growth coming into the second quarter. We are looking for a 25% YoY fall, following a 24% plunge in exports in the month. We recently cut our 2Q20 GDP growth forecast to -8.3% YoY from -6.6%, and the full-year 2020 forecast to -3.9% from -2.9%. The case for an additional 100bp of central bank (BNM) policy rate cuts in this easing cycle remains strong, which is likely by end-3Q20 and would take the rate to an all-time low of 1%.

Thailand: The Cabinet approved a draft bill imposing a 7% value-added tax on foreign tech companies operating in Thailand. The bill awaits parliamentary approval for it to become a law. This may be an added source of revenue for the government, but given the fact that the digital tax will be eventually borne by consumers, it will be an added drag on already weak demand".

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