Flash by EIC

SCB Economic Intelligence Center

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Mild market response to Fed's rate hike and announcement on balance sheet

Event

- The Federal Open Market Committee (FOMC) voted 8 to 1 in favor of raising its Fed Funds rate by 25 basis points to 1.00-1.25%, which is the second hike this year. Furthermore, the FOMC signals one more rate hike in this year. This will make the Fed Funds rate 1.25-1.50% at the end of 2017.

- The FOMC also unveiled its plan to unwind the Federal Reserve (Fed)'s balance sheet, which is expected to begin this year. Once it starts, the Fed will firstly stop reinvesting in matured U.S. treasuries and mortgage-backed securities (MBS) totaling USD 10 billion per month. The monthly amount will gradually increase until it hits USD 50 billion per month (see more details in Figure 1). Nonetheless, the Fed does not specify a clear starting date of the shrinking process.

Analysis

- **Strong domestic economic fundamentals contribute to the Fed's decision to raise its policy rates.** Despite the lowest GDP growth in a year at 1.2%QOQ SAAR in 1Q2017, the Fed views that the slowdown is temporary. Economic fundamentals point to signs of improvement, reflected by strong labor market and continued expansion in economic activities. U.S. unemployment rate hit a 16-year low at 4.3% in May. Additionally, the inflation rate, currently below the target of 2%, is expected to return to the target band in the medium term.

- **Markets have already priced in the Fed's hike before the announcement, resulting in a mild response in the global financial markets.** On the U.S. financial markets on June 14th, the USD depreciated slightly by 0.04% while the 10-year U.S. treasury yield ticked up only by 0.52 basis points to 2.1308%. The stock markets movement had no clear direction. The Dow Jones Industrial Average closed 0.22% higher, in contrast to S&P 500 index, closed 0.10% lower. Volatility index (VIX index) pushed up only 2.1%, reflecting no significant change in investors' view on risk in global financial market. In Thai market, the SET index slightly rose 0.04% in the morning after the rate hike, and the THB strengthened by 0.08%.

- **The Fed will likely hike rate another 25 basis points this year, in line with the dot plot, and might start shrinking its balance sheet in the last quarter**

of the year. The Fed signaled its confidence in the US economic recovery by raising its 2017 GDP growth forecast to 2.2% from 2.1%, released in March, and announcing the plan to reduce the size of balance sheet earlier than expected. Moreover, the very low unemployment rate reflects strong underlying private consumption. Therefore, it is likely that the Fed will begin unwinding its balance sheet in the last quarter of the year.

- **Nonetheless, the Fed could delay its rate hike if key economic indicators soften and political uncertainty escalates.** Although the Fed is confident in the current state of the U.S. economy, it has lowered inflation forecast below the target. Retail sales in May contracted by 0.3% MOM, possibly signaling an economic slowdown in the upcoming periods. Even though political factors do not dictate the Fed's policy decision, a scenario of adverse political development and possibility of President Trump's impeachment could prompt political uncertainty that affects consumer confidence and domestic investment. This circumstance could delay the Fed Funds rate hike and plan of unwind balance sheet. According to the CME Group, investors see the probability of another Fed's hike this year at 44.8%, down from 52.8% three months ago.

Implication

- **EIC expects the Bank of Thailand (BOT) to hold its policy rate at 1.50% until the end of 2017 despite the Fed's hike and start of shrinking the balance sheet.** The Thai economy has been improving shown by the steadily GDP growth at 3.3% in the first quarter this year. A strong international financial position and the high level of foreign exchange reserves are positive factors. However, headline inflation remains low at -0.04% YOY in May, lower than the target band of 1-4% . Weak private investment justifies the BOT's decision to hold the policy rate low to accommodate economic recovery going forward.

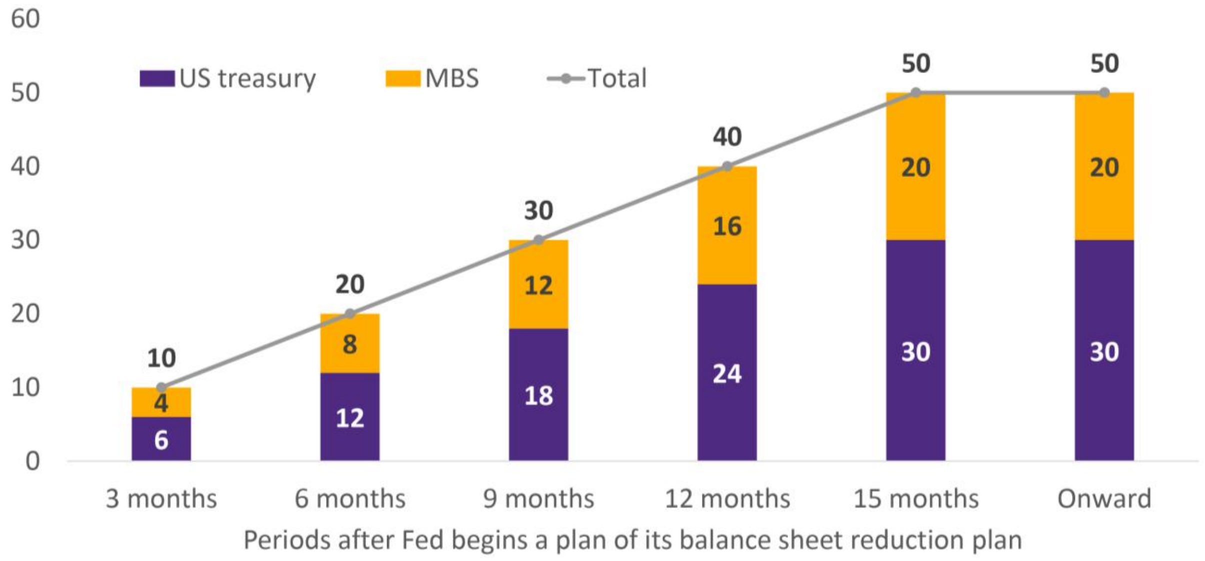
- **During before Fed begins to unwind balance sheet, THB is expected to continue its appreciation path, which could have potential impact on Thai exporters.** The THB is under pressure from capital inflow into the bond market as U.S. political uncertainty and poor progress on tax reforms, weakening the USD. Thai exporters are at risk of losing price competitiveness to counterparts in Vietnam, the Philippines, and Indonesia whose currencies depreciate against THB.

- **Going forward, when the Fed shrinks its balance sheet, those who need to raise fund will be exposed to rising borrowing costs.** The Fed's balance sheet reduction will shrink the U.S. money supply, pushing up 10-year U.S. treasury yields. In addition, capital flows will be back to the US, strengthening the USD. As for the Thai financial markets, the shrinking Fed's balance sheet will also push up 10-year Thai government bonds yield and weaken the THB. Therefore, firms that need to raise fund from the bond market should take into consideration of higher borrowing cost. Importers should also hedge risks of weak baht.

Figure 1: The Fed's plan for balance sheet reduction

Size of the Fed's balance sheet over time

Unit: USD billion per month



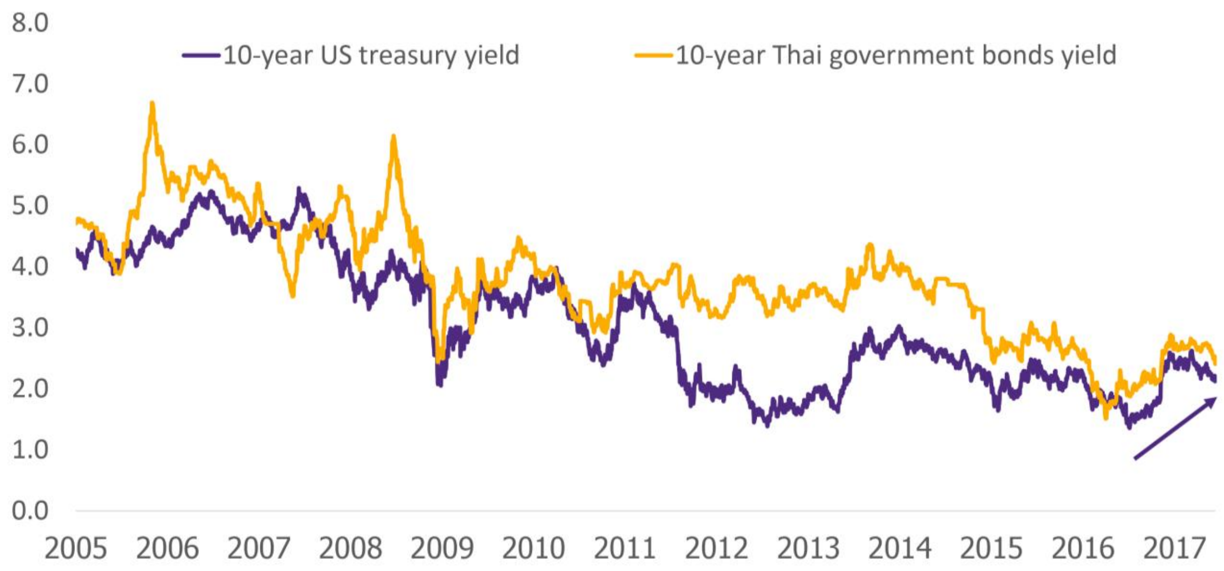
Source: EIC analysis

The Fed's balance sheet reduction plan is to stop reinvesting in the principal of securities when they mature. The targeted assets are US treasuries and mortgage-backed securities (MBS). In the first 3 months of the plan, the Fed will stop reinvesting in US treasuries and MBS by USD 6 and 4 billion per month, respectively. This totals to USD 10 billion per month. The Fed will continue to reinvest in maturing bonds above these suggested amounts. Subsequently, the Fed will increase the suggested amounts by additionally every USD 10 billion per month (US Treasuries by USD 6 billion per month and MBS by USD 4 billion per month) in every three months. When the suggested amounts reach USD 50 billion per month (US Treasuries at USD 30 billion per month and MBS at USD 20 billion per month), the Fed will hold the pace until the balance sheet is unwound to its desired level. Note that the Fed does not specify the time it will start the process nor its desired level of balance sheet.

Figure 2: Rising 10-year US Treasury yields could increase 10-year Thai government bonds yields.

Yields of 10-year US Treasuries and 10-year Thai government bonds

Unit: %



Source: EIC analysis based on data from Bloomberg

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