Flash by EIC

27 September 2018

The Fed hiked rate despite ongoing trade war and risks of invested yield curve

Event

- Following the Federal Open Market Committee (FOMC) meeting on 25 – 26 September 2018, the FOMC voted unanimously in favor of raising its federal funds rate (Fed funds rate) by 25 bps, to a range between 2.00 and 2.25%. Moreover, the dot plot indicated that the FOMC left its normalization path unchanged as the previous meeting, where it continued to project one more rate hike toward the end of the year, 3 more hikes in 2019, and one more hike in 2020.

Analysis

- **The U.S. economy's stronger growth supported the Fed's rate hike.** The U.S. economy grew 4.2%QOQ SAAR in the second quarter, the highest rate in 4 years, supporting the Fed to raise its growth forecasts for 2018 and 2019 to 3.1%YOY and 2.5%YOY from previous forecasts of 2.8%YOY and 2.4%YOY. Furthermore, the Fed expected the economy to expand 1.8%YOY in 2021 in line with its long-term growth forecast. With regard to the labor market, the Fed viewed that employment remained strong, as reflected from the unemployment rate that stabilized at 3.9% in August and non-farm payrolls that increased by around 200 thousand in August. However, the Fed raised its unemployment forecast for 2018 slightly to 3.7% from 3.6%. Moreover, the headline inflation PCE remained close to the target of 2%, which was due to a continued expansion of consumer spending, wage recovery, as well as a rise in global crude prices. The PCE forecasts for 2018 and 2019 stood at 2.1% and 2.0% respectively. Thus, the U.S. economy that remained strong was a supporting factor for the Fed's rate hike as previously communicated.

- **In the FOMC statement, the word "accommodative policy" was removed. Moreover, the statement did not mention any concerns regarding trade war.** Nevertheless, dropping out "accommodative policy" only reflected that a continuous rise in the Fed funds rate would bring the rate closer toward a neutral rate. However, it did not signal a faster pace of policy normalization going forward than it has previously communicated. Moreover, Powell, Chairman of the Fed, said after the meeting that overall financial conditions of the U.S. remained accommodative. Regarding trade war, the issue was not mentioned during the press conference. However, Powell mentioned after the meeting that the Committee has been monitoring and acknowledged concerns of businesses over such issue, but there

Disclaimer : The information contained in this report has been obtained from sources believed to be reliable. However, neither we nor any of our respective affiliates, employees or representatives make any representation or warranty, express or implied, as to the accuracy or completeness of any of the information contained in this report, and we and our respective affiliates, employees or representatives expressly disclaim any and all liability relating to or resulting from the use of this report or such information by the recipient or other persons in whatever manner. Any opinions presented herein represent our subjective views and our current estimates and judgments based on various assumptions that may be subject to change without notice, and may not prove to be correct. This report is for the recipient's information only. It does not represent or constitute any advice, offer, recommendation, or solicitation by us and should not be relied upon as such. We, or any of our associates, may also have an interest in the companies mentioned herein.

had yet to be any significant impact from trade war on the U.S. economy at present.

- **Overall, the median of the Fed's dot plot remained unchanged,** although details of the dot plot were slightly different from the June meeting[1] after a change of two of the FOMC members entitled for voting. The two members were John C. Williams, President of the New York Fed, who succeeded retired William Dudley, and Richard Clarida, the new Vice Chair of the Fed. Nevertheless, most of the FOMC members maintained similar views as before where it is likely that the Fed will hike rate one more time in December 2018, 3 more in 2019 and another one in 2020.

- **The rate hike was as market expected, resulting in a mild response in financial markets.** After the Fed's meeting on 26 September 2018, U.S. stock market fell slightly, with the Dow Jones Industrial Average closed 0.4% lower. Similarly, the S&P 500 index closed 0.33% lower. Meanwhile, the dollar index strengthened 0.13%. while the 10-year U.S. treasury yield dropped slightly to 3.05%. This afternoon, the baht was largely unchanged from yesterday's close of 32.43 baht per U.S. dollar.

Implication

- **EIC views that the financial crisis arising in emerging markets will not affect the Fed's monetary policy conduct as the pass-through to the U.S. were limited.** Apart from financial crises in Argentina and Turkey in recent periods, there are also concerns on a continuous tightening of the Fed's monetary policy which may have an impact on the global economic expansion, especially in some emerging markets with weak external stability and economic vulnerabilities[2]. However, EIC views that the Fed will maintain its normalization path as previously communicated as the Fed still put domestic economy as its first priority. In addition, the pass-through of the impact to the U.S. is largely limited as the current U.S. regulations to control and manage risks of financial institutions are more stringent than before, where credits extended to emerging markets has been reduced and businesses and financial sector in the U.S. also reduced their investment in highly risky counterparties or financial institutions. As a result, there are now less concerns that financial crises abroad will

---

[1] The December's dot plot indicated that 12 out of 16 FOMC members saw one more hike. The number increased from the June's dot plot where only 8 members saw one more hike. In addition, the median of the neutral rate rose from 2.9% to 3% at this projection period.

[2] Governors of the Central Bank of India and Bank Indonesia both shared views on the continuous tightening of monetary policy of the Fed which will have an impact on overall global economic expansion, especially financial markets of emerging markets that will have to face higher volatilities. Thus, they called for Fed's consideration of the impact from its monetary policy conduct.

Disclaimer : The information contained in this report has been obtained from sources believed to be reliable. However, neither we nor any of our respective affiliates, employees or representatives make any representation or warranty, express or implied, as to the accuracy or completeness of any of the information contained in this report, and we and our respective affiliates, employees or representatives expressly disclaim any and all liability relating to or resulting from the use of this report or such information by the recipient or other persons in whatever manner. Any opinions presented herein represent our subjective views and our current estimates and judgments based on various assumptions that may be subject to change without notice, and may not prove to be correct. This report is for the recipient's information only. It does not represent or constitute any advice, offer, recommendation, or solicitation by us and should not be relied upon as such. We, or any of our associates, may also have an interest in the companies mentioned herein.

have impacts on the U.S. economy compared to past events such as the Latin American financial crisis (1980s) or the Asian financial crisis (1997). However, the channel of pass-through from emerging markets to the U.S. to be monitored going forward is through "risk sentiment" channel because investors' concerns may pose negative impact on the U.S. stock market and thus tighten the U.S. financial conditions.

- **Although there is a risk of inverted yield curve, this may not be a good indication of a recession as before.** The Fed's continuous rate hikes may result in inverted yield curve in the period ahead. However, the current environment is different from the past as there are some technical factors causing a low long-term U.S. government bond yield. Such factors include the Fed's unconventional policy where the Fed bought long-term bonds resulting in a squeezed term premium. Moreover, the Fed's forward guidance helped adjust investors' expectations. Thus, long-term inflation expectations did not sufficiently rise. As a result, long-term U.S. government bond yield did not rise as much as before, so risk of inverted yield curve increased. Nevertheless, inverted yield curve this time may not reflect views of investors toward future growth as good as before.
- **The near-term forward spread did not signal any possibility of a U.S. recession.** The Fed has conducted studies to find indicators for a future recession, where it found that the near-term forward spread calculated from a spread between yield of 3-month treasury bill and its expected yield in the next 6 quarters will be a better indicator for a future recession than the 2-to-10-year yield spread. This is because the near-term forward spread is not affected by the QE measure of the Fed. In Figure 2, the near-term forward spread remains volatile and largely sideways and is unlikely to decline unlike the 2-to-10-year yield spread. Thus, there is still no sign of a future recession in the U.S.
- **The Fed's continuous rate hike has impacts on financial stability of emerging markets, resulting in rate hikes in some countries in tandem.** The Fed's continuous rate hikes led to narrower spread between rates of the U.S. and emerging markets. This resulted in fund flows out of emerging markets, especially those with economic vulnerabilities (such as continuous current account deficits and low internal reserves). Therefore, central banks in certain countries with fragile external stabilities, such as Indonesia, India, and the Philippines, had to raise policy rates in tandem with the U.S. in order to curb capital outflows which may negatively affect countries' financial stability.
- **EIC views that monetary policy decisions of the Thai MPC will depend more on appropriateness of the monetary policy to the state of the Thai economy rather than the Fed's rate hike.** Although the Fed is likely to continue raising its rate leading to a wider spread between rates of the U.S. and Thailand, EIC does

Disclaimer : The information contained in this report has been obtained from sources believed to be reliable. However, neither we nor any of our respective affiliates, employees or representatives make any representation or warranty, express or implied, as to the accuracy or completeness of any of the information contained in this report, and we and our respective affiliates, employees or representatives expressly disclaim any and all liability relating to or resulting from the use of this report or such information by the recipient or other persons in whatever manner. Any opinions presented herein represent our subjective views and our current estimates and judgments based on various assumptions that may be subject to change without notice, and may not prove to be correct. This report is for the recipient's information only. It does not represent or constitute any advice, offer, recommendation, or solicitation by us and should not be relied upon as such. We, or any of our associates, may also have an interest in the companies mentioned herein.

not think that the MPC will increase the policy rate at a faster pace as Thailand has strong external stability, both from high level of current account surplus and large international reserves to accommodate volatile capital flows. Therefore, the MPC is likely to focus on financial stability given risks of a prolonged low interest rate, inflation outlook that is likely to remain within policy target for the remainder of the year, and a continued economic expansion. EIC expects the MPC's first rate hike at the first MPC meeting next year or sooner at the meeting in December 2018. However, the policy rate hike cycle this time will rather be more gradual than in the past.

(For more details: https://www.scbeic.com/th/detail/product/4997)

Figure 1: Emerging markets and external stabilities

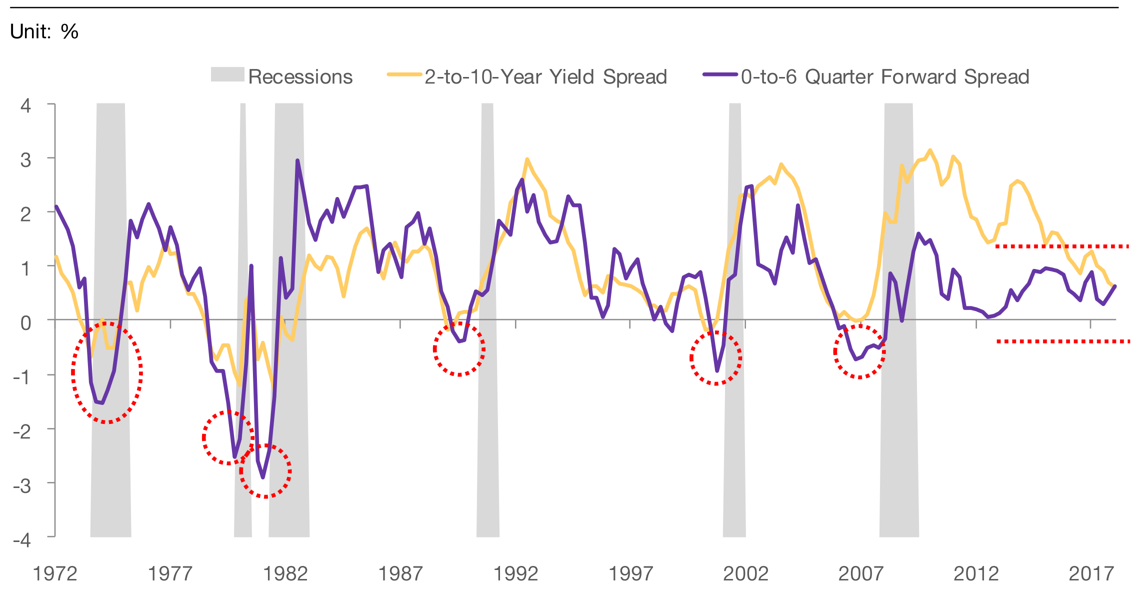
	Exchange rate (% Chg YTD)	Inflation (%YOY, 1Q2018)	Current Account (% of GDP, 2018)	External debt (% of GDP, 2017)
Turkey	61.4%	10.3%	-5.4%	53.4%
Argentina	100.3%	25.8%	-5.1%	36.5%
South Africa	16.0%	4.1%	-2.9%	49.6%
Indonesia	10.0%	3.3%	-1.9%	34.7%
Brazil	23.5%	2.8%	-1.6%	32.5%
India	14.4%	4.6%	-2.3%	19.7%
Philippines	9.1%	3.8%	-0.5%	23.3%
Thai	-0.4%	0.6%	9.3%	32.7%

Source: EIC analysis based on data from Bloomberg

Disclaimer : The information contained in this report has been obtained from sources believed to be reliable. However, neither we nor any of our respective affiliates, employees or representatives make any representation or warranty, express or implied, as to the accuracy or completeness of any of the information contained in this report, and we and our respective affiliates, employees or representatives expressly disclaim any and all liability relating to or resulting from the use of this report or such information by the recipient or other persons in whatever manner. Any opinions presented herein represent our subjective views and our current estimates and judgments based on various assumptions that may be subject to change without notice, and may not prove to be correct. This report is for the recipient's information only. It does not represent or constitute any advice, offer, recommendation, or solicitation by us and should not be relied upon as such. We, or any of our associates, may also have an interest in the companies mentioned herein.

Figure 2: 2-to-10-year yield spread may not clearly signal a recession this time

2-to-10 Year Yield Spread and 0-to-6 Quarter Forward Spread



Source: EIC analysis based on data from Federal Reserve Bank of New York

By : Chinnachod Thaerapanyaporn (chinnachod.thaerapanyaporn@scb.co.th)

Economic Intelligence Center (EIC)

Siam Commercial Bank Public Company Limited EIC Online: www.scbeic.com

Disclaimer : The information contained in this report has been obtained from sources believed to be reliable. However, neither we nor any of our respective affiliates, employees or representatives make any representation or warranty, express or implied, as to the accuracy or completeness of any of the information contained in this report, and we and our respective affiliates, employees or representatives expressly disclaim any and all liability relating to or resulting from the use of this report or such information by the recipient or other persons in whatever manner. Any opinions presented herein represent our subjective views and our current estimates and judgments based on various assumptions that may be subject to change without notice, and may not prove to be correct. This report is for the recipient's information only. It does not represent or constitute any advice, offer, recommendation, or solicitation by us and should not be relied upon as such. We, or any of our associates, may also have an interest in the companies mentioned herein.