Investec

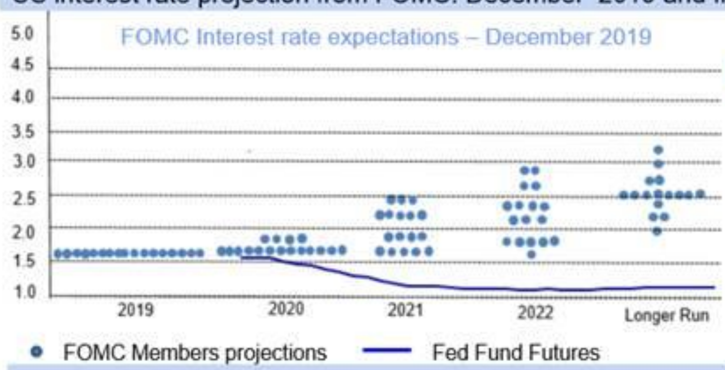
# SA Economics

## FOMC Note

Thursday 20 February 2020

The FOMC minutes continue to show comfort at the current level of interest rates, with the market divergence in interest rate expectations, yesterday showing over 85% chance of rate cuts, likely to begin to reduce

US interest rate projection from FOMC: December 2019 and Implied Probabilities




Current Implied Probabilities

| Meeting Dates | 1.5-1.75% | Fwd Rate |
|---|---|---|
| 18/3/2020 | 91.7% | 1.56% |
| 29/4/2020 | 75.0% | 1.52% |
| 10/6/2020 | 54.2% | 1.45% |
| 29/7/2020 | 41.1% | 1.39% |
| 16/9/2020 | 28.3% | 1.31% |
| 5/11/2020 | 24.9% | 1.28% |
| 16/12/2020 | 16.8% | 1.20% |
| 27/1/2021 | 14.1% | 1.16% |

Source: Reuters and Federal Reserve Bank

- The US Federal Open Market Committee's minutes of its January 29th meeting was published last night, and reveals the relatively high degree of comfort of the FOMC for leaving interest rates unchanged as per the last dot plot. Market implied future possibilities of rate cuts yesterday were for about two 25bp cuts this year.

- When US markets open today yesterday's perceived 85.9% probability of cuts in US interest rates this year is likely to dim, and the rand has already weakened to R15.09/USD, R16.28/EUR and R19.47/GBP this morning from its close yesterday of R14.99/USD, R16.20/EUR and R19.36/GBP.

- US interest rate cuts tend to strengthen the rand as it improves the opportunity for yield seeking and so can make EM assets more attractive. SA offers relatively high real yields, although yesterday's rise in CPI inflation to 4.5% y/y from 4.0% y/y reduced real yields somewhat, and likely also contributed to rand weakness.

- Supporting an unchanged US interest rate view, the FOMC minutes revealed that "(p)articipants generally saw the distribution of risks to the outlook for economic activity as somewhat more favorable than at the previous meeting", with the strong performance of the US economy also bolstering the neutral FOMC view.

- The FOMC will remain data dependent as usual, and if data starts to come in which threatens the positive outlook for the US economy, and in particular indicates a weakening in key areas, then the FOMC will likely become significantly more dovish, particularly in its communications, and then in its stance.

- The FOMC highlights improvements in some areas including the "easing of trade tensions resulting from the recent agreement with China and the passage of the USMCA as well as tentative signs of stabilization in global economic growth helped reduce downside risks and appeared to buoy business sentiment."

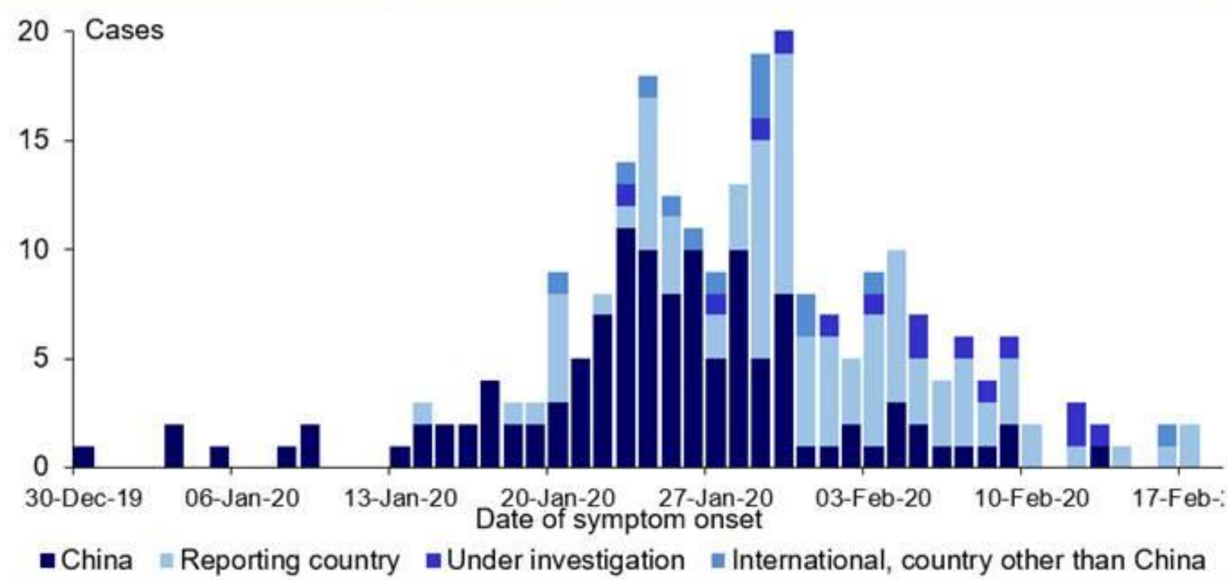
- The FOMC adds that "(t)he risk of a 'hard' Brexit had appeared to recede further. In addition, statistical models designed to estimate the probability of recession using financial market data suggested that the likelihood of a recession occurring over the next year had fallen notably in recent months."

- However, "a number of downside risks remained prominent. … participants generally expected trade-related uncertainty to remain somewhat elevated, and they were mindful of the possibility that the tentative signs of stabilization in global growth could fade."

- Furthermore, "(g)eopolitical risks, especially in connection with the Middle East, remained. The threat of the coronavirus, in addition to its human toll, had emerged as a new risk to the global growth outlook, which participants agreed warranted close watching."

- The World Health Organisation (WHO) is working urgently "with an international network of statisticians and mathematical modellers" to better understand "the incubation period, case fatality ratio (the proportion of cases that die) and the serial interval (the time between symptom onset of a primary and secondary case)."

Epidemic curve of COVD-19 cases (n = 231) identified outside of China,, by date of onset of symptoms and travel history 19 February 2020




Source: World Health Organisation

Note: Of the 924 cases reported outside China 29 were detected while apparently asymptomatic. For the remaining 895 cases, information on date of onset is available only for the 231 cases presented in the epidemiologic curve.

- The latest stats continue to show the rate of infection is slowing in China, but this is not the case in all countries. South Korea showed 20 new cases, Japan 8 and the Diamond Princess cruise liner 88, which has also contributed to some risk-off sentiment in markets this morning, and so contributed to rand weakness.

- The WHO's strategic objectives include "(l)imit(ing) human-to-human transmission", such as "reducing secondary infections among close contacts and health care workers, preventing transmission amplification events, and preventing further international spread from China".

- Markets are seeing the reopening of Chinese factories as a test for the spread of the epidemic, although they are not expected to be fully operational this month. A two week lag time has also been noted by some in the medical field in the infection path of the virus.

- Until the hard data begins coming out in the PMIs and other data prints for February and March, the quantified effect of Covid-19 on industrial production globally will remain unclear, particularly the effect on the global supply chain. Even then data into Q2.20 will be needed to assess the impact on countries' growth rates.

- The latest WHO data shows 2009 fatalities from Covid-19, and 75 204 infected so far, with 1 872 new cases globally on the day before, 120 of which are not in China. Outside of China there are 924 cases in 25 countries with 3 deaths. In China there have been 1 752 new cases on the day before, with 136 new deaths.

- The impact on US growth from Covid-19's impact on the global supply chain is so far expected to be minimal. China's industrial production is expected to contract in Q1.20, slowing the Chinese economy's growth in 2020. This would impact global growth, negatively affecting exports to China.

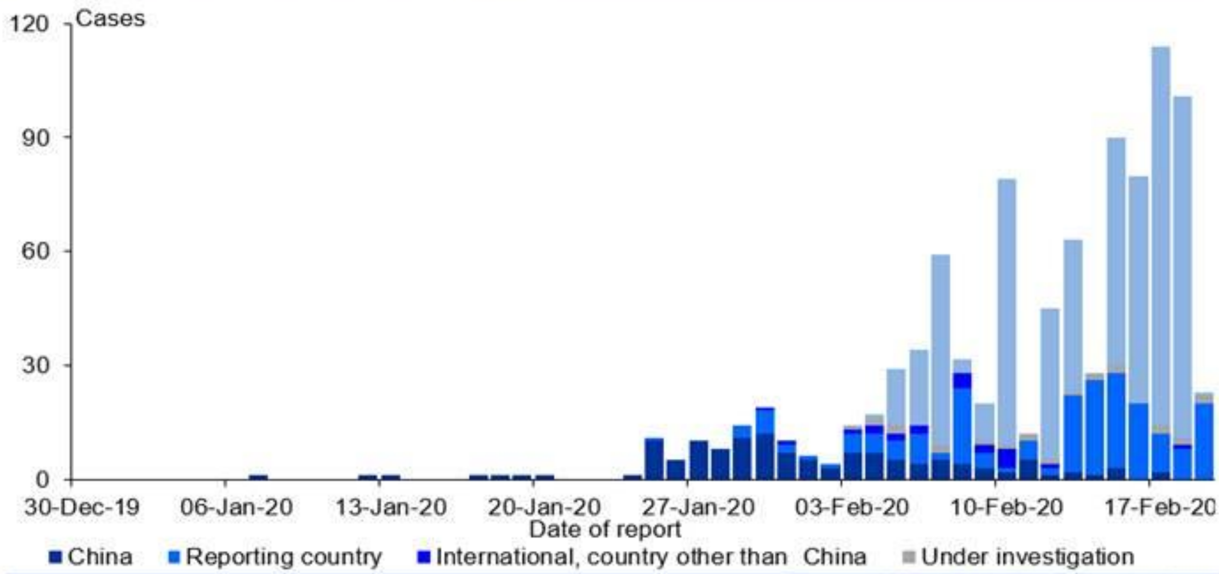
- Stimulus measures from China are expected to provide some alleviation, with monetary policy easing from China and a few other countries already this year, although the US is signalling quite strongly that currently this is not likely in the US. However, the economic outcomes of Covid-19 could alter the Fed's view.

- Indeed, the FOMC minutes shows its concerns that "a persistently accommodative policy stance that is otherwise consistent with the dual-mandate goals may contribute to an increase in financial system vulnerabilities, including through increased borrowing, financial leverage, and valuation pressures."

- The Fed adds "that keeping policy rates low … may contribute to a build-up of financial vulnerabilities, especially at times when the economy is at or above full employment, a development that could pose future risks to the economy and to the ability of the Committee to achieve its dual mandate."

- The risks continue to stack up for the rand, as high political tensions domestically hold-up the implementation of key policy reforms in SA, while globally last year's synchronisation of monetary policy looks likely to lessen, while the risk premium in the rand is rising as markets fear a greater likelihood of a Moody's downgrade.

Epidemic curve of COVID-19 cases (n = 294) identified outside of China, by date of report and likely exposure location, 19 February 2020




Source: World Health Organisation