On the minds of investors

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Does the Fed signal matter for Asia and EM?

At their most recent meeting the Federal Reserve (Fed) left key U.S. policy rates unchanged. However, in-line with market expectations, the Federal Open Market Committee (FOMC) has shifted to a more dovish view on their forecast for the U.S. economy and interest rates. The FOMC's statement suggests a more cautious outlook and a bias towards easing policy later this year, leaving open the possibility of a rate cut in July. We currently expect the Fed to cut rates twice this year, given persistently low inflation, slowing economic growth and continued trade uncertainty which will weigh on consumers and businesses.

The European Central Bank and the Fed have acknowledged the risks to the global economy and shown a willingness to act. This shift to more monetary policy support continues globally and will likely influence policy in Asia, compelling central banks in the region to also make a move to cut rates. Low inflation has also allowed them to halt or reverse tightening cycles. Most central banks have already started signaling a dovish tilt. Amongst those that have yet to cut rates, such as Taiwan, they have lowered GDP growth projections, or adopted other liquidity injection measures, such as lowering the reserve requirement ratio for banks in Indonesia.

The return of rate cuts from the Fed or other central banks on the horizon doesn't always mean outperformance for Asia or emerging markets. Historically, U.S. rate cuts only appear to have significant consequences if the U.S. dollar (USD) is affected. A weak USD typically has meant that Asia and emerging markets will outperform relative to developed markets, but the USD does not always fall when the Fed cuts rates. Our long-term view on the USD is that it will still weaken due to issues with U.S. fiscal and current account deficits. However, other issues remain in play such as global growth momentum, commodity prices and domestic political idiosyncrasies that can drive currency movements in the shorter term. What may also have an influence on currency strength are interest rate differentials between countries and the impact on liquidity flows. With the Fed on pause and looking to cut rates, emerging markets are able to concentrate on their local issues and also cut rates to support slowing growth. Differentials have stabilized or may even widen in the case for countries where central banks will cut rates further than the Fed. We believe this will be more pronounced in Asia where low inflation and less political issues will give them an advantage over Latin America and Middle East countries.

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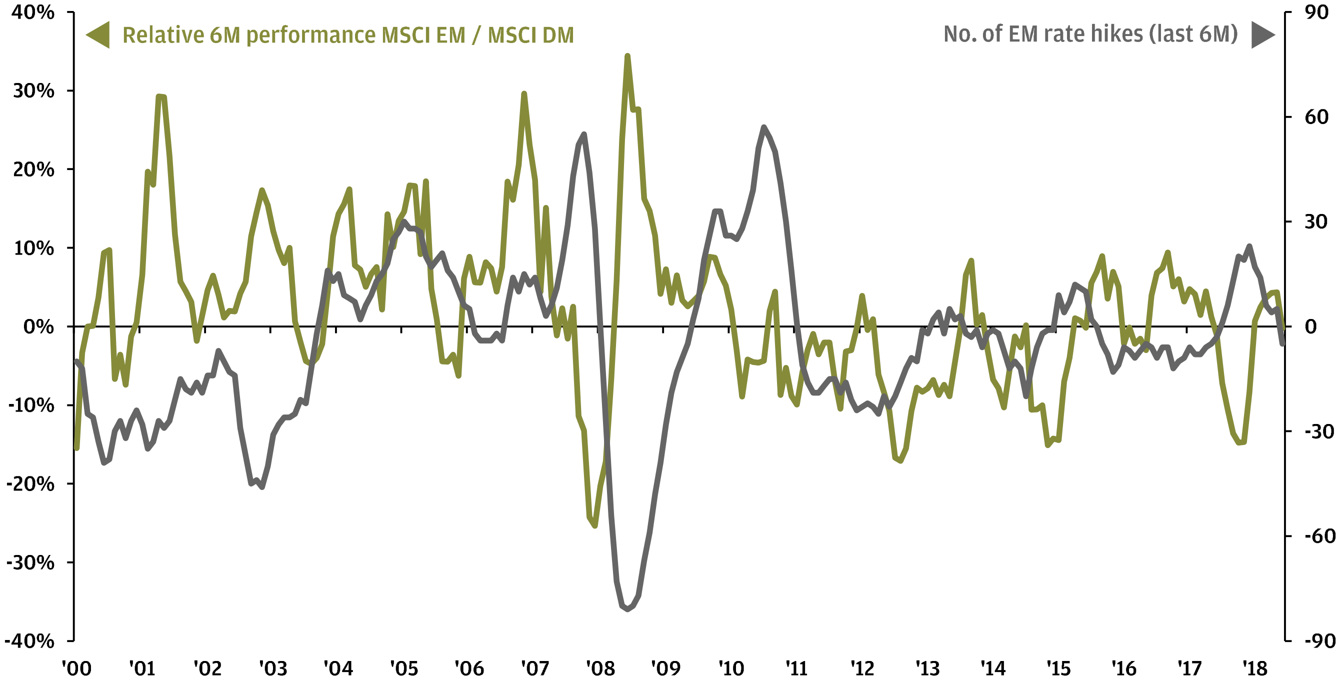
EXHIBIT 1: MONETARY EASING IN EMERGING MARKETS IS LESS OF A SUPPORT FOR EQUITIES THAN ONE MIGHT THINK

OUTSIDE OF RECESSIONS (2002-03 & 2008-09) NO SUSTAINABLE OUTPERFORMANCE OF EM WHEN CENTRAL BANKS ARE CUTTING RATES



Source: Bloomberg, J.P. Morgan Asset Management. Data reflect most recently available as of 26/6/19.

Investment implications

The Fed all but outright confirming a shift away from their next move being a rate cut is a helpful move for Asia and emerging markets. Other central banks have followed this shift, but just monetary easing in general is less supportive for emerging market equities than one might think. Other factors remain, but widening interest rate differentials in Asia is likely to give the region more of a equity market performance boost compared to other EM regions where issues still linger. Falling interest rates in the U.S. will also make USD emerging market debt more attractive due to the chase for yield. Higher coupons available will be a much more appealing proposition than the sub 2% rate on offer in the U.S. if the current situation continues.