Economic Research, Strategic Management

Thursday, August 1 2019 / 29 Zulkaedah 1440H

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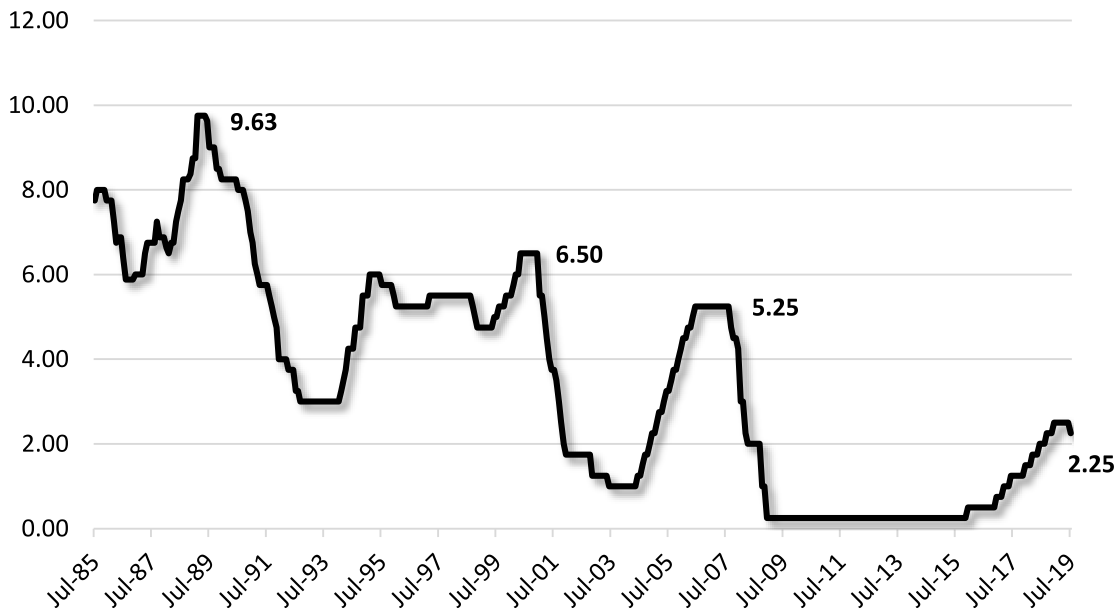
US FOMC – insuring against downside risk

Facts

- In the most anticipated Federal Open Market Committee (FOMC) meeting (30-31 July), the US Fed delivered the 25 basis points (bps) reduction in the policy rate. The Federal Fund Rate (FFR) is now at 2.00% - 2.25% from the previous level of 2.25%-2.50%.
- This was the first interest rate cut since September 2007 whereby the US Fed reduced the FFR by 50 bps from 5.25% to 4.75% in a move to resuscitate the economic activities during the Sub Prime Crisis in 2007.
- The accompanying statement indicates that the labour market is solid, judging from the gains in the number of total employment, which led to more spending among the households.
- However, business investment has been soft while inflation rate is running below the 2% target.
- The decision was not unanimous. Two of the 10 FOMC voting member dissented as both of them opted to vote for a no change in the FFR. The next FOMC meeting will be held in 17-18 September 2019.

Chart 1: US Federal Fund Rate (FFR)



Source: Bloomberg

Our view

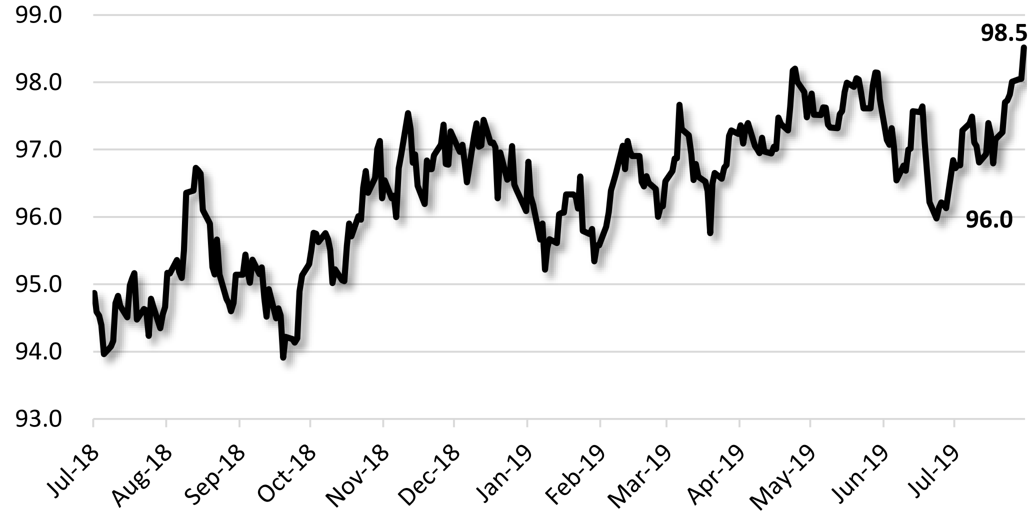
While the decision was not a surprise, the tone from the Fed Chairman, Jerome Powell, was somewhat disappointing from the market perspective. Markets seems to hope for a more decisive rate cut, perhaps to the tune of 50 bps reduction. However, the accompanying statement and press conference suggests that the Fed is still sanguine about their assessment on the economy. To put it aptly, the latest decision was merely buying an insurance against the downside risks and to sustain the current economic expansion. What does this mean to Malaysia? US Dollar Index has gone up to 98.5 points yesterday, giving 2.5% increases compared to end of June. Therefore, USDMYR would be on a weaker bias. From the technical standpoint, the ringgit is currently hovering at the current resistance level of RM4.1461 and the next resistance level is located at RM4.1678 per US dollar. **Following this, we maintained our year-end target of RM4.21.**

On monetary policy, this has opened up more space to Bank Negara Malaysia (BNM) should they decide to prescribe additional monetary easing. This is good for economic growth as companies and households would have cheaper cost of funds in the event of lower Overnight Policy Rate (OPR). However, this could be negative for banks as Net Income Margin (Islamic Banks) or Net Interest Margin (NIM) would be compressed further should the BNM follow the same footsteps with their US counterpart.

Having said that, the lower interest rate environment has become more prevalent. In fact, the European Central Bank (ECB) is expected to reignite another round of Quantitative Easing (QE) measures, perhaps as soon as September this year. In that sense, from portfolio allocation, fixed income assets could be more appealing in view of the possible decline in the bond yields. Already, the 3- and 10-year MGS yields have gone down by 3 and 6 basis points on month-on-month basis to 3.27% and 3.57% respectively at the end of the July.

In nutshell, the economy is on high alert.

Chart 2: US dollar index



Source: Bloomberg

Appendix – FOMC Statement

Information received since the Federal Open Market Committee met in June indicates that the labor market remains strong and that economic activity has been rising at a moderate rate. Job gains have been solid, on average, in recent months, and the unemployment rate has remained low. Although growth of household spending has picked up from earlier in the year, growth of business fixed investment has been soft. On a 12-month basis, overall inflation and inflation for items other than food and energy are running below 2 percent. Market-based measures of inflation compensation remain low; survey-based measures of longer-term inflation expectations are little changed.

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. In light of the implications of global developments for the economic outlook as well as muted inflation pressures, the Committee decided to lower the target range for the federal funds rate to 2 to 2-1/4 percent. This action supports the Committee's view that sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective are the most likely outcomes, but uncertainties about this outlook remain. As the Committee contemplates the future path of the target range for the federal funds rate, it will continue to monitor the implications of incoming information for the economic outlook and will act as appropriate to sustain the expansion, with a strong labor market and inflation near its symmetric 2 percent objective.

In determining the timing and size of future adjustments to the target range for the federal funds rate, the Committee will assess realized and expected economic conditions relative to its maximum employment objective and its symmetric 2 percent inflation objective. This assessment will take into account a wide range of information, including measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial and international developments.

The Committee will conclude the reduction of its aggregate securities holdings in the System Open Market Account in August, two months earlier than previously indicated.

Voting for the monetary policy action were Jerome H. Powell, Chair; John C. Williams, Vice Chair; Michelle W. Bowman; Lael Brainard; James Bullard; Richard H. Clarida; Charles L. Evans; and Randal K. Quarles. Voting against the action were Esther L. George and Eric S. Rosengren, who preferred at this meeting to maintain the target range for the federal funds rate at 2-1/4 to 2-1/2 percent.