Economic Research, Strategic Management
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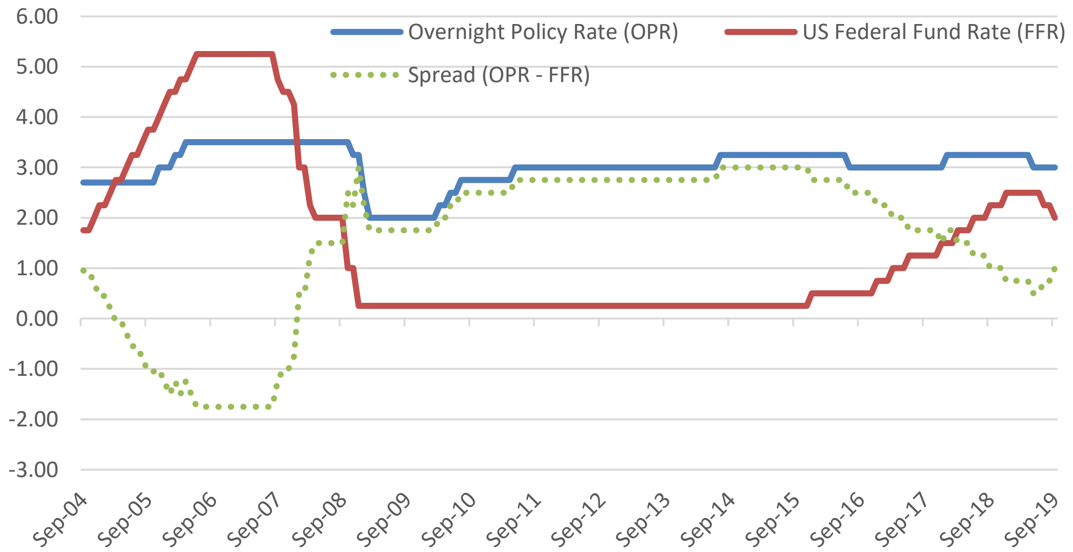
Dr. Mohd Afzanizam Abdul Rashid | Chief Economist | 03-2088 8075 | afzanizam@bankislam.com.my
Shafiz Jamaluddin | Economic Analyst| 03-2088 8399 | shafiz@bankislam.com.my
Nor Jannah Abdullah | Economic Analyst| 03-2782 1417 | norjannah@bankislam.com.my
Shakeena Mirza Mohamed Tariq Beg | Young Leadership Program (YLP)| 03-2088 8754 | shakeena@bankislam.com.my

The US Fed cut rates again by 25 basis points

Facts

- As expected, the US Federal Reserve delivered their 25 basis points cut in the Federal Fund Rate (FFR) during their two-day meeting which ended last night. This will bring the FFR from 2.00%-2.25% to 1.75%-2.00%, the second reduction this year.
- The accompanying statement suggests the Fed is still sanguine about the state of the economy especially on consumer spending which has been resilient amidst steady unemployment rates.
- However, the central bank acknowledged that the business fixed asset investment and the global economy have been wobbly, insinuating that intervention on the part of the monetary authorities are needed.
- The decision was not entirely unanimous as one of the voting member for Federal Open Market Committee (FOMC) voted for a 50 basis points cut. Meanwhile, two other members preferring the rates to remain at status quo.
- While positive assessment on the state of the economy was clearly communicated, the door for possible reduction remains widely open. There are two meetings left for the 2019 session. The upcoming meeting will be on 29-30 October and the final meeting for the year will be on 10-11 December. Judging from the interest rate futures contract, the markets seems to expect for another 25 basis point FFR reduction in December meeting.

Chart 1: Malaysia's Overnight Policy Rate (OPR) vs. US Federal Fund Rate (FFR)



Source: Bloomberg

Our view

The reduction in FFR is certainly positive for the global and Malaysian economy. At the current juncture, Malaysia's Overnight Policy Rate (OPR) spread (see Chart 1) against the FFR stood at 100 basis points (3.00% minus 2.00%). This would mean BNM has more leeway to reduce the OPR should they wish to do so. Such prognosis is important as the prospect for global growth is highly uncertain following the ongoing trade war between the US and China, UK Brexit, geo political development in the Middle East and volatility in the crude oil prices. The recent survey from the Institute of Supply Management (ISM) indicates that the Purchasing Managers Index (PMI) for the US manufacturing sector has fallen below the 50-point benchmark in August to 49.1 points (July: 51.2 points). Based on the survey responses, several industries continued to express their concern on the impact from the trade war to their business and some explicitly worried about the potential recession (chemical products).

Table 1: Responses from the US ISM manufacturing survey

No.	Industries	Responses
1	**Computer & Electronic Products**	1) They are seeing some relief in the availability of electronic components in the marketplace, but there are still short of supply, allocation, long lead times and the like. 2) Tariffs continue to be a strain on the supply chain and the overall economy.
2	**Chemical Products**	While business is strong, there is main concern pertaining to the trade wars and a potential recession.
3	**Transportation Equipment**	Slowest sales recorded in July this year.
4	**Food, Beverage & Tobacco Products**	Late planting of the corn and soybean crops has increased uncertainty over the final acres and yields. This is leading to volatile markets.
5	**Fabricated Metal Products**	Slightly lower rate of incoming orders may be seasonal or a sign of a general slowdown. As such, they will monitor the situation closely.
6	**Furniture & Related Products**	1) Incoming sales seem to be slowing down. 2) Concerns about the economy and tariffs.
7	**Machinery**	Business is starting to show signs of a broad slowdown.
8	**Miscellaneous Manufacturing**	Generally, business remains steady. However, they continue to plan for a hard Brexit and a long trade war between the U.S. and China.
9	**Nonmetallic Mineral Products**	The market for large building structures is slowing.
10	**Plastics & Rubber Products**	Current business is acceptable but production is slightly below than last year.

Source: Institute for Supply Management, ISM

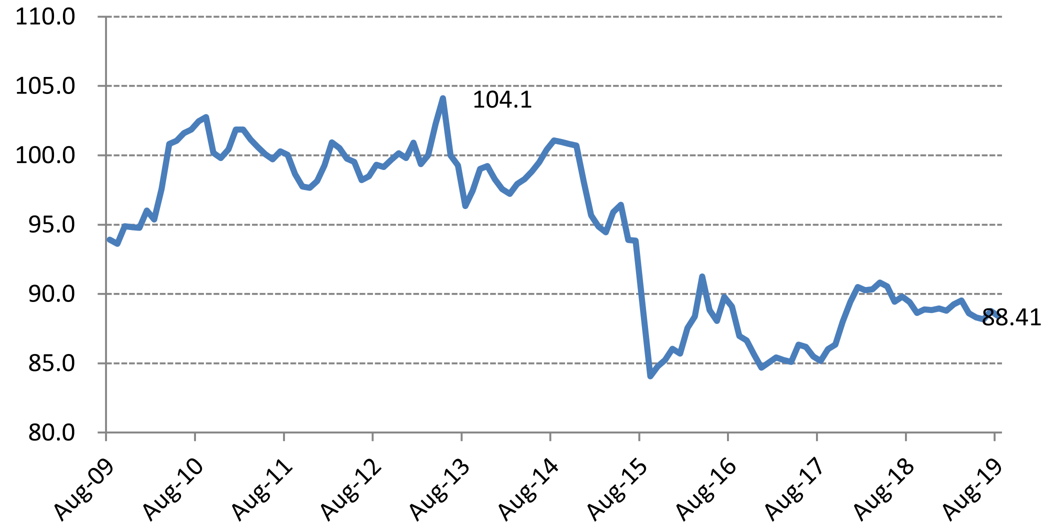
As such, we expect the risk-off mode will, intermittently, affect the market sentiments as positive news (US-China meeting in October) on the trade war would provide a slight relief. Notwithstanding that, the situation is still fluid and demand for the safe haven currencies and instrument will outdo most of the asset class.

In that regards, **we continue to maintain our call for USDMYR at RM4.21 by year-end while in 2020, we are expecting to ringgit hover around RM4.20 – RM4.30**. This was primarily driven by the growing concern on the global growth next year and typically, demand for safe haven currencies (US dollar and Japanese Yen) would be higher. Otherwise, the USDMYR is extremely undervalued and the currency pair should return to its fair value at some point in the future. The average level for the USDMYR since the currency peg was removed in July 2005 stood at RM3.59. Additionally, the Real Effective Exchange Rate (REER) currently stood at 88.41 points as of August 2019, implying 11.6% undervaluation (see Chart 2). In a nutshell, the ringgit has the potential to rise in value but this will hinges greatly upon on the global growth prospects.

On the OPR, the room for further reduction is visible. Inflation rate is very low at 0.3% for the first seven months while private investment has been very lethargic for several quarters. However, concern on ringgit could be the stumbling block. The decision on the FTSE Russell on the membership of Malaysia's government securities in the World Government Bond Index (WGBI) is seen to be very critical. This was due to their last review in March which they have indicated our govvies would be removed. Such remarks was based on Market Accessibility Levels which currently our govvies has been assigned at "2". In the FTSE Russell statement, should Malaysian bonds downgraded to "1", our govvies will not be eligible for the inclusion in WGBI.

If that happens, there is a chance that passive foreign funds managers who tracks WGBI would rebalance their fixed income portfolio. This would mean selling off our govvies to reflect the new WGBI constituent. In short, the concern is on ringgit and the reduction of OPR would accentuate the possible weakening of the currencies. FTSE Russell is expected to announce their decision sometime this month. **For now, we maintain our OPR call at 3.00% in 2019.**

Chart 2: MYR Real Effective Exchange Rate (REER)



Source: Bloomberg

Appendix

FOMC Statement

Information received since the Federal Open Market Committee met in July 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 household spending has been rising at a strong pace, business fixed investment and exports have weakened. 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 1-3/4 to 2 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.

Voting for the monetary policy action were Jerome H. Powell, Chair, John C. Williams, Vice Chair; Michelle W. Bowman; Lael Brainard; Richard H. Clarida; Charles L. Evans; and Randal K. Quarles. Voting against the action were James Bullard, who preferred at this meeting to lower the target range for the federal funds rate to 1-1/2 to 1-3/4 percent; and Esther L. George and Eric S. Rosengren, who preferred to maintain the target range at 2 percent to 2-1/4 percent.