Have bond traders given their blessings for a further rate hike?

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Summary

- The US government's strategy to issue more UST bills to refill the TGA seems to be succeeding as it encourages MMFs to get out of RRP while keeping liquidity within the banking system.
- The outlook for the US economy may not be as bad as indicated by the record inversion in the yield curve as banks continue to distribute credit despite the tightening liquidity conditions.
- Market sentiments seem to be moving towards another 25 bps rate hike in the Jul-23 FOMC meeting given the US economy's still-robust performance

- Much has been discussed about the potentially negative impact of the US government's treasury general account (TGA) refill following the debt-ceiling agreement on the liquidity conditions in the US economy. This hypothesis stems from the observed weakening demand for US treasury (UST) securities from the Fed (due to quantitative tightening) and foreign investors amidst the escalating geopolitical tensions. Many analysts are concerned that such a scenario could result in a shift of liquidity from banks to the UST market, further worsening the liquidity conditions in the US banking system and increasing the likelihood of a sudden credit crunch.
- The US government wasted no time in replenishing its Treasury General Account (TGA) following the debt-ceiling agreement, raising USD 243.6 Bn in the four weeks following its nadir in late May-2023. More significant is that this TGA refill did not result from significant withdrawals in bank reserves ***(see Chart 1)***. Instead, the recent UST issuance has hitherto succeeded in unlocking the 'dormant' liquidity in the Fed's RRP facility, which we recognise as the best scenario out of this short-term liquidity risk.
- The US government's successful TGA refill campaign, successful because it refills the government's coffer without exacerbating the liquidity stress in the banking sector, could be attributed to two factors. The first factor is the almost-exclusive issuance of UST bills following the debt-ceiling agreement ***(see Chart 3).*** The negative spread between UST bills and the overnight RRP rate, along with duration risks associated with UST

securities, resulted in the accumulation of funds in the Fed's RRP facility from February to April 2023. However, currently, the more attractive yield offered by UST bills ticks most of the boxes for MMFs, encouraging MMF managers to increase holdings of UST bills in their portfolio.

- The second factor contributing to the success of the TGA refill campaign is the Fed's continued liquidity support through the Bank Term Funding Programme ***(****BTFP****, see Chart 2).*** The BTFP facility, of course, enables banks to avoid realising losses on their HTM assets – limiting the risk of short-term liquidity stress from escalating into profit-ability risks for banks.

- Ergo, the developments in the US sovereign market following the debt-ceiling agreement suggest that the outlook for Main Street in the US may not be as bleak as indicated by the record-inversion in the yield curve for UST securities. The yield curve, of course, has been inverted for some time as the post-pandemic optimism soon gives way to the debilitating inflation (and higher interest rates it entails). However, further inversion to the yield curve may not be taken as an augur of the worsening outlook for the US economy.

- Instead of the usual shift in demand from UST bills to UST notes/bonds typical in the lead-up to a recession, the increasingly-higher yield on UST bills is more explainable by the influx of new UST bills rather than sell-offs. At the same time, the lower yield on longer-term UST securities should also be considered in the context of the declining supply of UST notes/bonds. Thus, while we did not discount the significance of an inverted yield curve as a recession indicator, **the increasingly-inverted yield curve should not be taken as an indicator of the severity of the forthcoming recession**.

- The fact that the surge in new UST securities in Jun-2023 has not yet crowded out liquidity from the banking sector adds to the argument that bond traders may be overpricing the probability and the severity of a US recession in the short term. Indeed, bank loans continue to record positive growth in the dying days of Q2-2023, which hardly reflects a credit crunch albeit the pace continued to slow ***(see Chart 4)***. We should note, of course, that FOMC members have revised their projection for US GDP growth in 2023 to 1.0%, an increase from the 0.4% projection made in March 2023 which justifies for the Fed to double down on their hawkish outlook. Some in the market have been increasingly open to the idea that the Fed would increase the FFR by another 25 bps in the upcoming FOMC meeting ***(see Chart 6).***

"Holding on to Indonesia's tried-and-true growth model may result in long-term complications"

- The increasing acceptance of the Fed's "*higherer*-for-longer" outlook may pose a challenge for riskier, more peripheral markets, including Indonesia. Indeed, the Indonesian financial market recorded capital outflows amounting to USD 119.6 Mn in the last week, driven by the sell-off in the capital market (-USD 115.9 Mn in foreign capital stock) following the conclusion of the 2023 dividend cycle and the weakening earnings outlook.

- However, this sell-off should not sound the alarm for Bank Indonesia. As discussed in an earlier report *(TFP W25: Fragile no more),* the Indonesian economy's prudent fiscal and current account balances would help instil confidence in investors despite the uncertain global liquidity conditions. The limited risk of capital outflows would enable Bank Indonesia to explore ways to complement the government's fiscal expansion and sustain domestic consumption growth. However, the pursuit for additional capital inflows may become increasingly challenging given the prevailing global hawkish outlook while the continued appreciation of IDR assets may incentivise investors to realise their profits and explore opportunities in other markets.

"Holding on to Indonesia's tried-and-true growth model may result in long-term complications"

Chart 1

Taking it from the right purse

The US government's TGA refill operation has been successful in drawing liquidity from RRP while keeping liquidity in the bank reserves

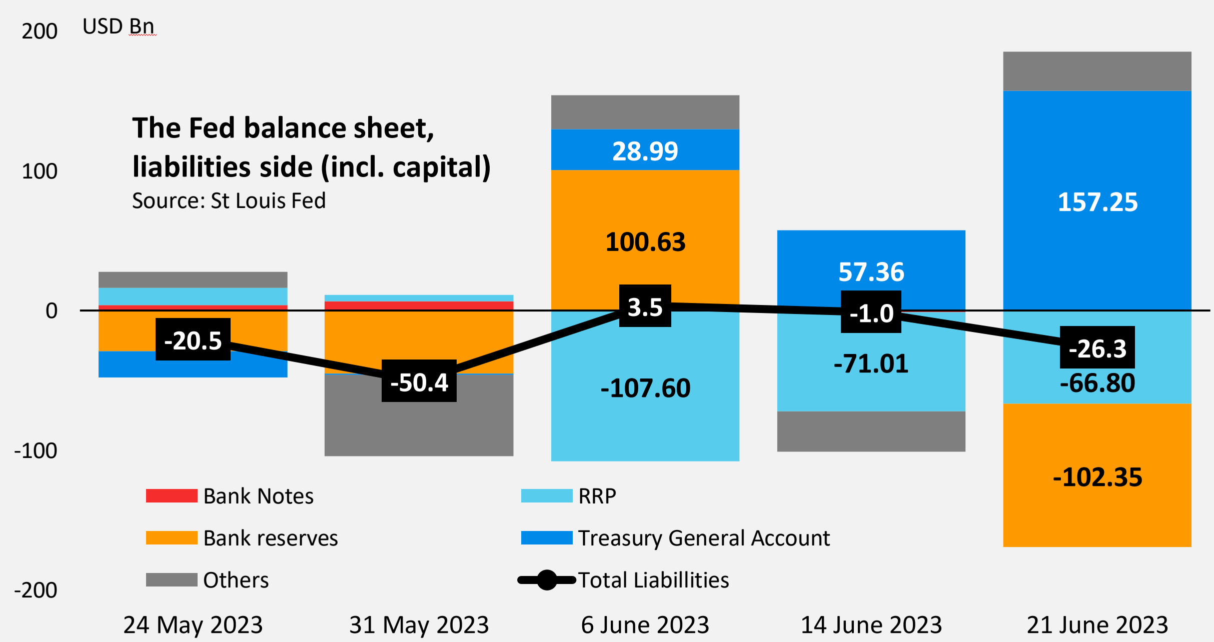


Chart 2

A new and better tool

Banks appear to prefer BTFP over more-conventional primary credit facilities. Liquidity supports through BTFP also allows the Fed to continue its liquidity-tightening programme.

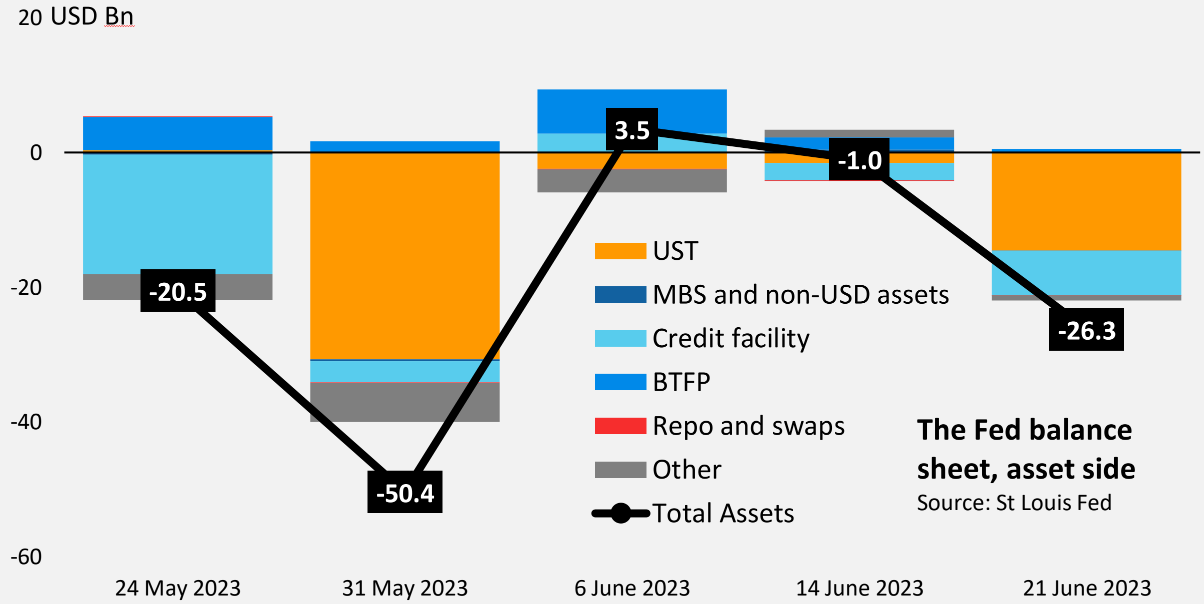
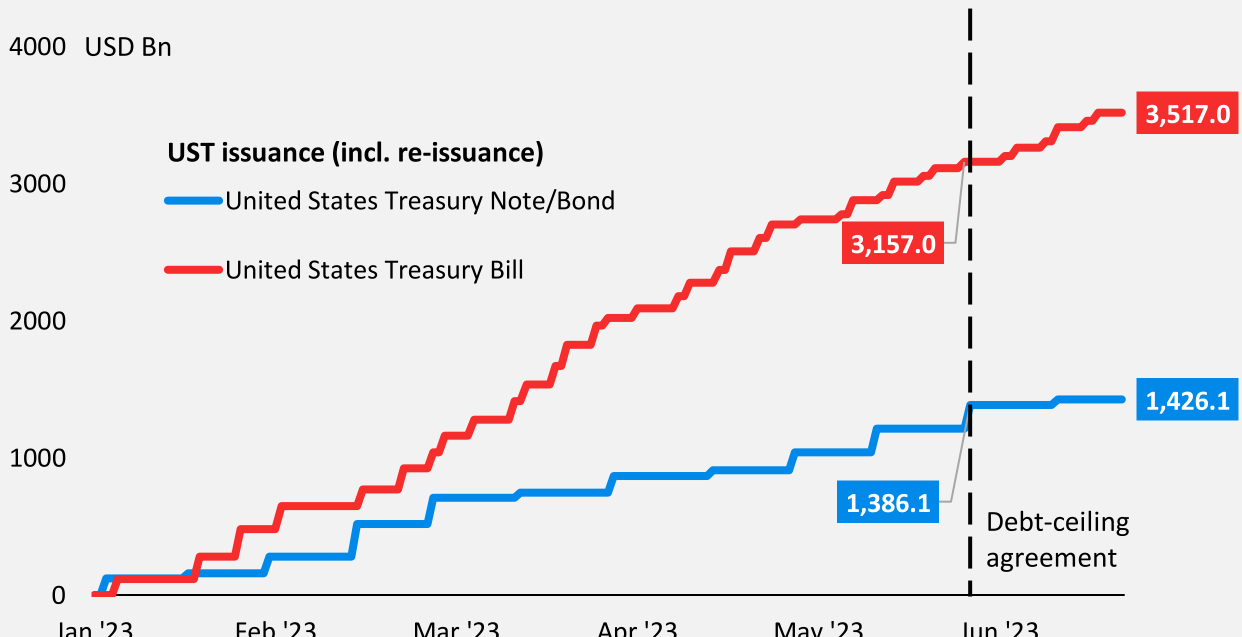


Chart 3

Duration-free

The US Treasury Department's strategy to issue more UST bills rather than UST treasuries helps to encourage MMF managers to leave RRP for the UST market

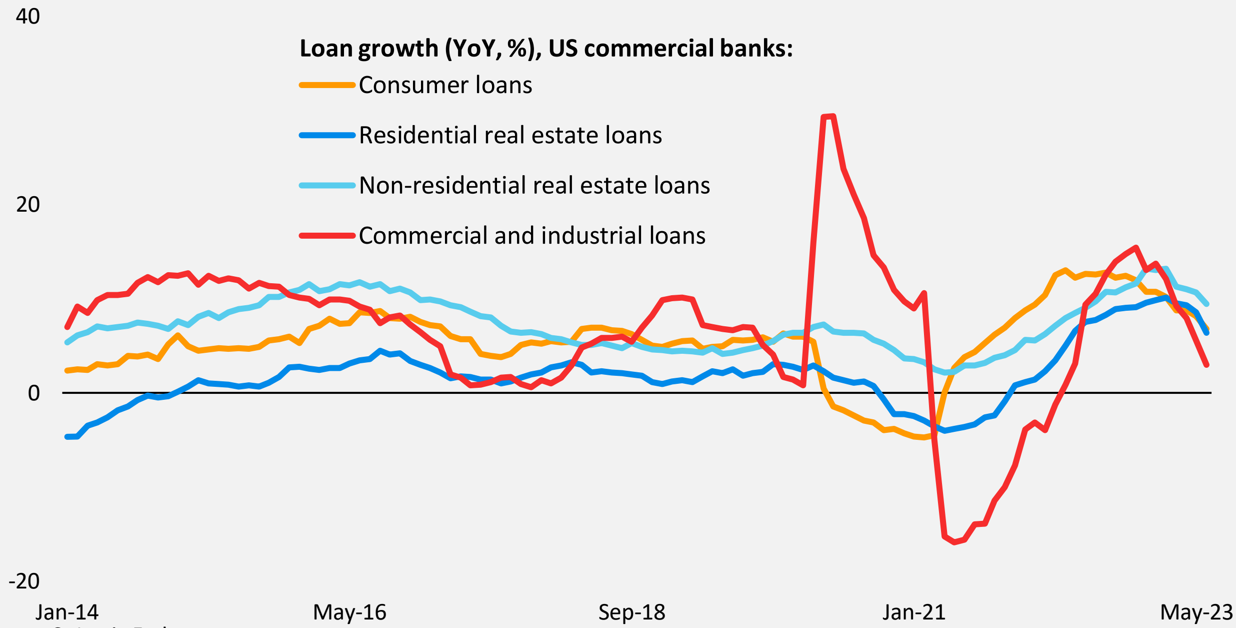


Source: Bloomberg

Chart 4

Not necessarily a crunch

US banks do not find it too hard to distribute new loans, albeit the pace has been slowing given the tightening credit conditions

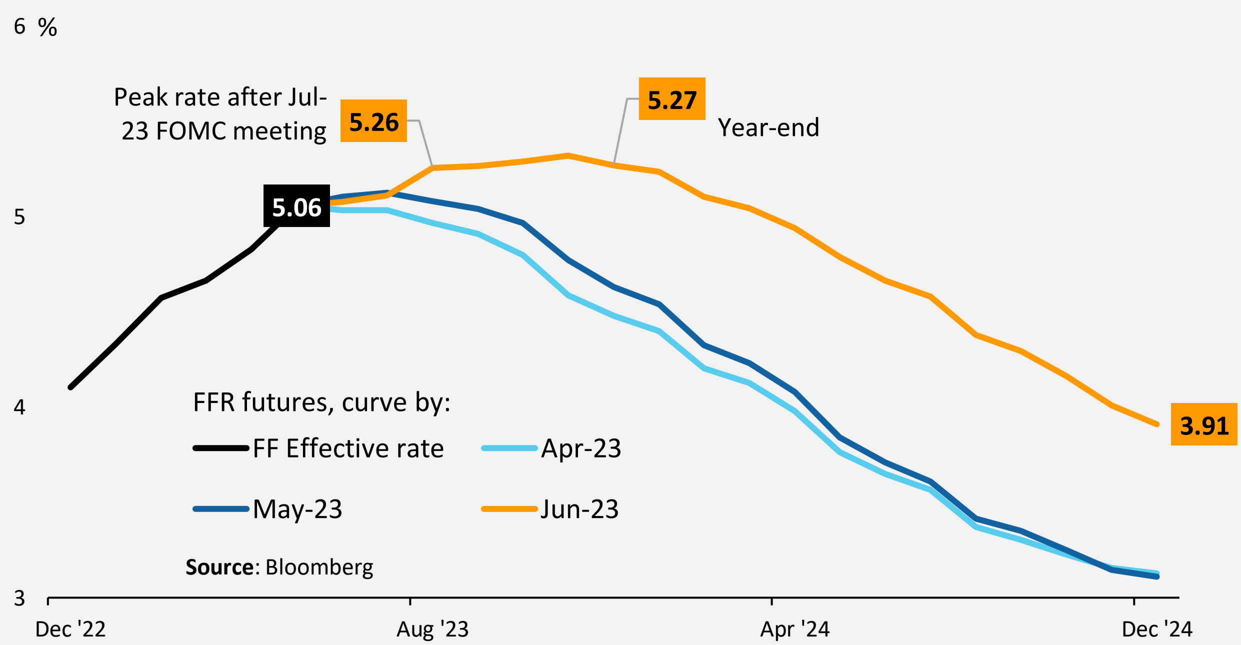


Source: St Louis Fed

Chart 5

The coast is clear for another rate hike

The US economy's pockets of strength help FOMC officials to sell their "*higherer*-for-longer" outlook to market participants



Source: Bloomberg

Economic Calendar

		Actual	Previous	Forecast*
1 June 2023				
US	ISM Manufacturing PMI	46.9	47.1	48
5 June 2023				
ID	S&P Global Manufacturing PMI	50.3	52.7	52.3
ID	**Inflation Rate YoY**	**4.0%**	**4.33%**	**4.2%**
7 June 2023				
CN	Balance of Trade (USD Bn)	65.81	90.21	91.0
US	Balance of Trade (USD Bn)	-74.6	60.6	-78.2
9 June 2023				
CN	Inflation rate YoY	0.2%	0.1%	0.2%
ID	**Foreign Exchange Reserves (USD Bn)**	**139.3**	**144.2**	**144.0**
12 June 2023				
ID	Consumer Confidence	128.3	126.1	128
13 June 2023				
ID	Retail Sales	1.5%	4.9%	5.0%
US	Inflation rate YoY	4%	4.9%	4.3%
15 June 2023				
US	Fed Interest Rate Decision	5.25%	5.25%	5.25%
ID	**Balance of Trade (USD Bn)**	**0.44**	**3.94**	**3.2**
ID	Car Sales YoY	65.2	-28.8%	-
19 June 2023				
ID	Motorbike Sales YoY	113.4%	-19.4%	-
22 June 2023				
ID	Loan Growth YoY	9.39%	8.08%	-
ID	**Bank Indonesia policy announcement**	**5.75%**	**5.75%**	**5.75%**

*Forecasts of some indicators are simply based on market consensus
Bold indicates indicators covered by the BCA Monthly Economic Briefing report

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Selected Macroeconomic Indicator

Key Policy Rates	Rate (%)	Last Change	Real Rate (%)
US	5.25	Jun-23	1.25
UK	5.00	Jun-23	-3.70
EU	4.00	Jun-23	-2.10
Japan	-0.10	Jan-16	-3.30
China (lending)	4.35	Jun-23	4.15
Korea	3.50	May-23	0.20
India	6.50	Jun-23	2.25
Indonesia	5.75	Jun-23	1.75
Money Mkt Rates	**23-Jun**	**-1 mth**	**Chg (bps)**
SPN (1M)	5.04	4.93	11.2
SUN (10Y)	6.28	6.42	-13.7
INDONIA (O/N, Rp)	5.61	5.53	7.7
JIBOR 1M (Rp)	6.39	6.40	-1.3
Bank Rates (Rp)	**Apr**	**Mar**	**Chg (bps)**
Lending (WC)	8.92	8.95	-2.71
Deposit 1M	4.18	4.20	-2.70
Savings	0.67	0.69	-1.70
Currency/USD	**23-Jun**	**-1 mth**	**Chg (%)**
UK Pound	0.787	0.806	2.42
Euro	0.918	0.929	1.15
Japanese Yen	143.7	138.6	-3.56
Chinese RMB	7.179	7.056	-1.72
Indonesia Rupiah	14,994	14,880	-0.76
Capital Mkt	**23-Jun**	**-1 mth**	**Chg (%)**
JCI	6,639.7	6,736.7	-1.44
DJIA	33,727.4	33,055.5	2.03
FTSE	7,461.9	7,763.0	-3.88
Nikkei 225	32,781.5	30,957.8	5.89
Hang Seng	18,890.0	19,431.3	-2.79
Foreign portfolio ownership (Rp Tn)	**May**	**Apr**	**Chg (Rp Tn)**
Stock	2,738.1	2,789.1	-51.06
Govt. Bond	822.7	822.7	0.00
Corp. Bond	11.8	11.8	-0.01

Trade & Commodities	23-Jun	-1 mth	Chg (%)
Baltic Dry Index	1,240.0	1,348.0	-8.0
S&P GSCI Index	541.6	546.5	-0.9
Oil (Brent, $/brl)	73.9	76.8	-3.9
Coal ($/MT)	140.9	159.8	-11.9
Gas ($/MMBtu)	2.22	2.22	0.0
Gold ($/oz.)	1,921.2	1,975.2	-2.7
Copper ($/MT)	8,409.2	8,035.7	4.6
Nickel ($/MT)	21,117.0	20,838.0	1.3
CPO ($/MT)	777.1	789.5	-1.6
Rubber ($/kg)	1.31	1.33	-1.5
External Sector	**May**	**Apr**	**Chg (%)**
Export ($ bn)	21.72	19.28	12.61
Import ($ bn)	21.28	15.35	38.65
Trade bal. ($ bn)	0.44	3.94	-88.91
Central bank reserves ($ bn)*	139.3	144.2	-3.38
Prompt Indicators	**May**	**Apr**	**Mar**
Consumer confidence index (CCI)	128.3	126.1	123.3
Car sales (%YoY)	65.2	-28.8	2.7
Motorcycle sales (%YoY)	113.4	-19.4	40.5
Manufacturing PMI	**May**	**Apr**	**Chg (bps)**
USA	46.9	47.1	-20
Eurozone	44.8	45.8	-100
Japan	50.6	49.5	110
China	50.9	49.5	140
Korea	48.4	48.1	30
Indonesia	50.3	52.7	-240

Source: Bloomberg, BI, BPS
Notes:
^Data for January 2022
*Data from an earlier period
For changes in currency: **Black indicates appreciation against USD, **Red** otherwise
***For PMI, **>50** indicates economic expansion, **<50** otherwise

Indonesia – Economic Indicators Projection

	2018	2019	2020	2021	2022	2023E
Gross Domestic Product (% YoY)	5.2	5.0	-2.1	3.7	5.3	5.0
GDP per Capita (US$)	3927	4175	3912	4350	4784	5285
Consumer Price Index Inflation (% YoY)	3.1	2.7	1.7	1.9	5.5	3.4
BI 7-day Repo Rate (%)	6.00	5.00	3.75	3.50	5.50	5.75
USD/IDR Exchange Rate (end of the year)**	14,390	13,866	14,050	14,262	15,568	15,173
Trade Balance (US$ billion)	-8.5	-3.2	21.7	35.3	54.5	35.3
Current Account Balance (% GDP)	-3.0	-2.7	-0.4	0.3	1.0	-0.7

*Estimated number

** Estimation of the Rupiah's fundamental exchange rate

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