FOMC:
Dazed and confused

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Executive Summary

- The triple shocks from the FOMC, US Treasury QRA, and fear of renewed banking crisis are rattling the US and global market, potentially leading to less favorable financial conditions and less room of rate cuts for EM countries like Indonesia
- The Fed appears to dismiss the chance of a March rate cut, although it remains open to the possibility of pivot in a data-dependent manner.
- Issuance of US federal debt for the next three months remains large and is skewed towards long-term instruments, potentially weighing down on risk asset valuations.
- In the short-term, the potential rise in LT yields are masked by concerns over large losses to a regional US bank (NYCB), although it is yet unclear if it is a systemic issue.

- The US (and therefore global) market enters February having suffered not one, not two, but three simultaneous gut punches that leave it quite disoriented. And what make these shocks even more shocking was the market's prior conviction—albeit slightly shaken in recent weeks—that the Fed would pivot sharply towards accommodative policies.

- Jerome Powell, with his first FOMC presser of the year, delivered the first punch. The Fed strikes a more optimistic tone on the US economy, and—most importantly—pushed back against the idea that the Fed will begin cutting in March. This seems to quash prevailing market expectations that the Fed would cut six times this year, and yields on the short-end rise accordingly.

- The implication of Powell's statements, however, is likely more nuanced. The door remains wide open for a rate cut this year, but instead of a clear forward guidance it now prefers a data-dependent approach that gives it more leeway over the timing of the pivot. It is not a hawkish move per se, but this "keep the market guessing" approach does add a layer of uncertainty that may prevent financial conditions from becoming too loose as during the market euphoria in December.

- The second punch comes from the US Treasury Department, which delivered its Quarterly Refunding Announcement (QRA). As we previously wrote, the QRA had been a major, but overlooked driver of market movements during H2-23, given the US government's outsized financing needs post-debt ceiling and amid high interest payments.

- During that time, the "size effect" of the debt issuance was somewhat offset by the "skew effect", as the US Treasury preferred issuing short-term debt (bills) over long-term instruments ("coupons"). The result was continued inversion of the yield curve, while liquidity moved from the Fed's overnight reverse repo (O/N RRP) facility in favor of bills.

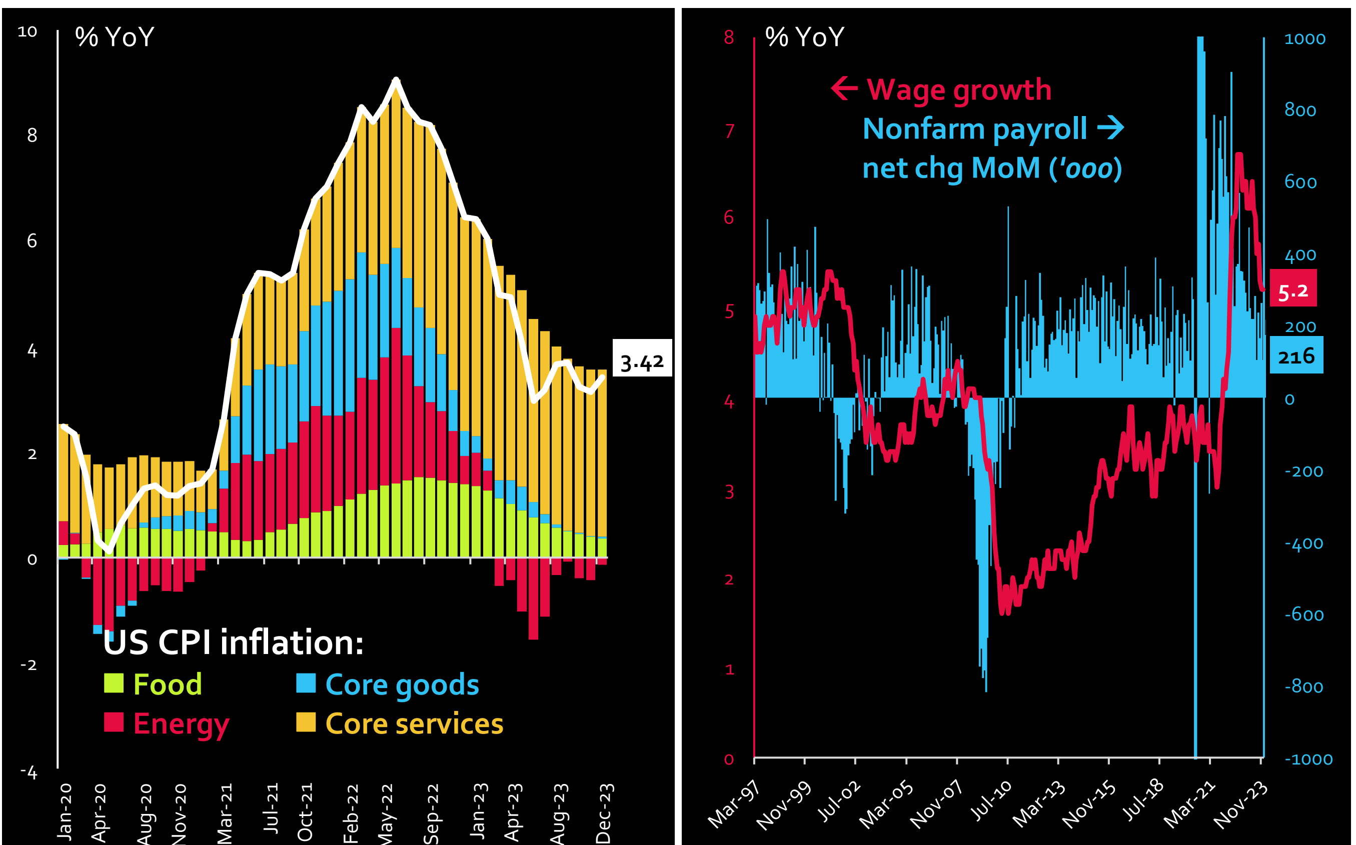
- This, however, complicates the Fed's effort to shrink its balance sheet via quantitative tightening (QT). With RRP drained and the Treasury's account balance with the Fed (TGA—Treasury General Account) replenished, any decrease in the Fed's balance sheet will have to come from bank reserves. In turn, this increases the risk of an "incident" the money market, similar to the repo rate spike in Sep-19.
- The latest QRA, then, may prove to be quite a pivotal one. According to one estimate, net coupon issuance for the next three months amounts to 519 Bn (up almost 50% QoQ), while net bill issuance is in the negative. In order to finance these UST notes and bonds, banks and asset managers would have unload their risk assets, implying lower valuation and increased term premia.
- On the flip side, the lighter bill burden should slow the pace of RRP drainage, therefore giving the Fed more room to proceed with QT. This would, of course, run contrary to market sentiment, where there have been speculations that the Fed will stop or at least "taper" its QT concurrently with the pivot.
- With this one-two punch, then, the Fed should in theory be winning the first round against the market. The former gets all its wishes—more QT, more freedom to pivot at its discretion—while the market does not get the looser financial conditions that it so craves. But there is a twist …
- … and that is the third punch: the return of banking crisis fears. In its latest filing for Q4, the New York Community Bancorp (NYCB) reported a loss of USD 252 Mn, with rising loan losses stemming in large part to its commercial real estate (CRE) exposures and its newly-acquired assets from Signature Bank—one of the US regional banks that collapsed in 2023. It is as yet unclear if this is a unique or systemic problem, but the stock market already reacts as if it was the latter.
- And, as it turns out, so does the bond market. The yield on 10Y UST has declined by about 12 bps (from 4.06% to 3.94% as of this writing), which would be inexplicable given the bond supply that is about to be unleashed post-QRA, but totally explicable if the market thinks that the Fed will be forced to "bail out" the banking system.
- The market's nervousness about banks is made even more acute given the Fed's announcement last week that it will discontinue the BTFP (Bank Term Funding Program), which had been the lifeline following last year's banking crisis. Without BTFP, banks in urgent need of liquidity will only have recourse to the Fed's discount window—the use of which is often heavily stigmatized by the market. It is possible, then, that the Fed will have to react to a banking liquidity crunch not in a selective manner as had been the case with BTFP (or, in theory, the discount window), but by once more "flooding the system" with liquidity through rate cuts or QE.
- Overall, such combination of monetary, fiscal, and banking shocks so early in the year illustrates the challenges that the global market faces in 2024. On one hand, a robust US economy, still-elevated inflation, and risks of further energy/geopolitical shocks dictate that the Fed should "slow ball" its pivot and therefore crimp global liquidity. What could hasten the pivot, on the other hand, are significant shocks either on US banks or the UST market—not terribly good news either.

- It should not surprise us, then, that the market is clinging to this scrap of bad news—NYCB losses—in a vociferous hope that the Fed would come to its rescue. If this turns out not to be a systemic crisis, however, we are left with a data-dependent Fed and large UST notes and bonds issuance still left to be digested by the market. Quite a roller-coaster ride, indeed, and one that justifies our cautious stance towards Fed/BI rate cuts and the Rupiah, especially for the first half of the year.

Panel 1. The Fed adopts a lower policy rate in its short-term outlook, but the widening spread in long-term rate expectation shows that the hawkish expectation remains in the picture

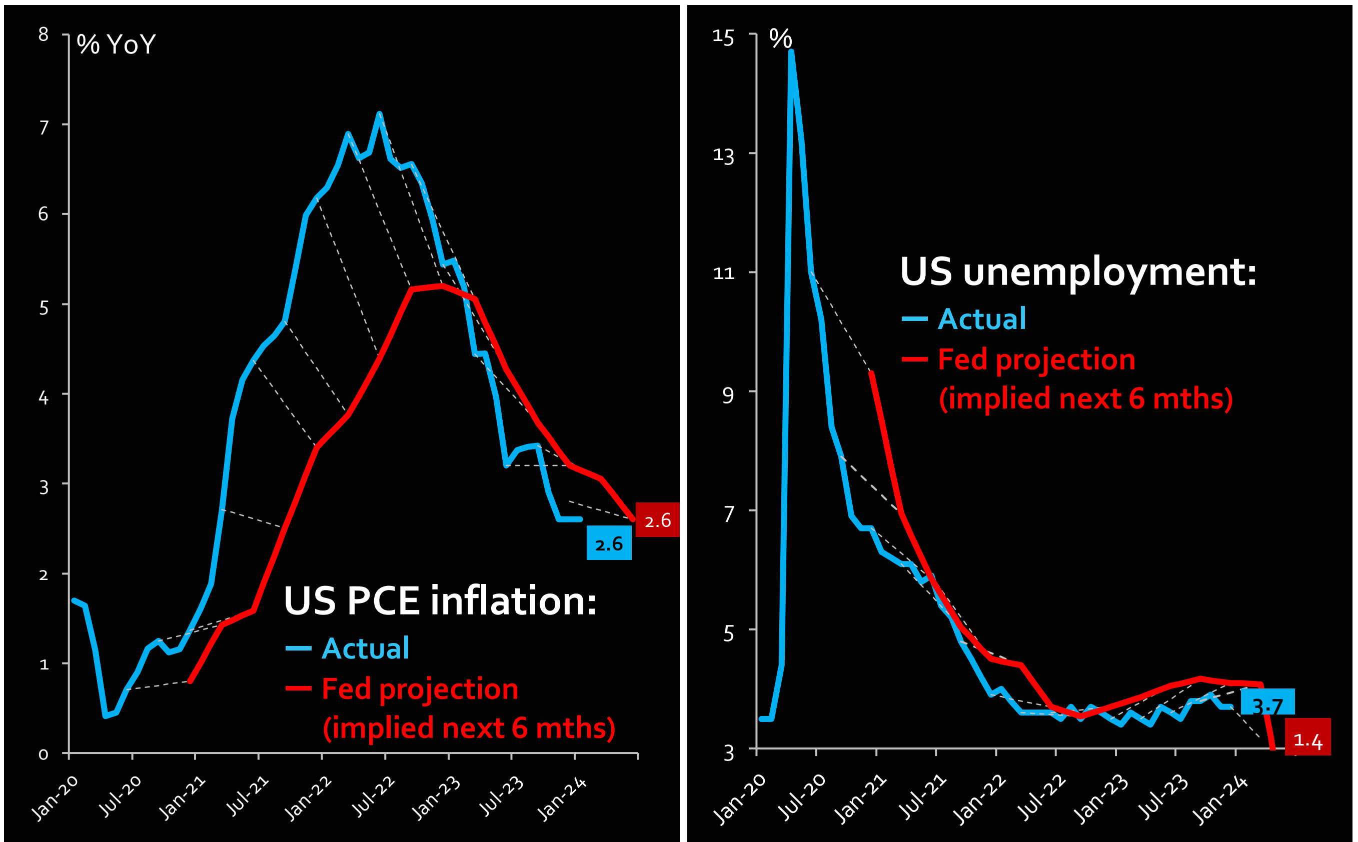
Source: Federal Reserve

Panel 2. Energy has been the main source of US inflation volatility in recent months



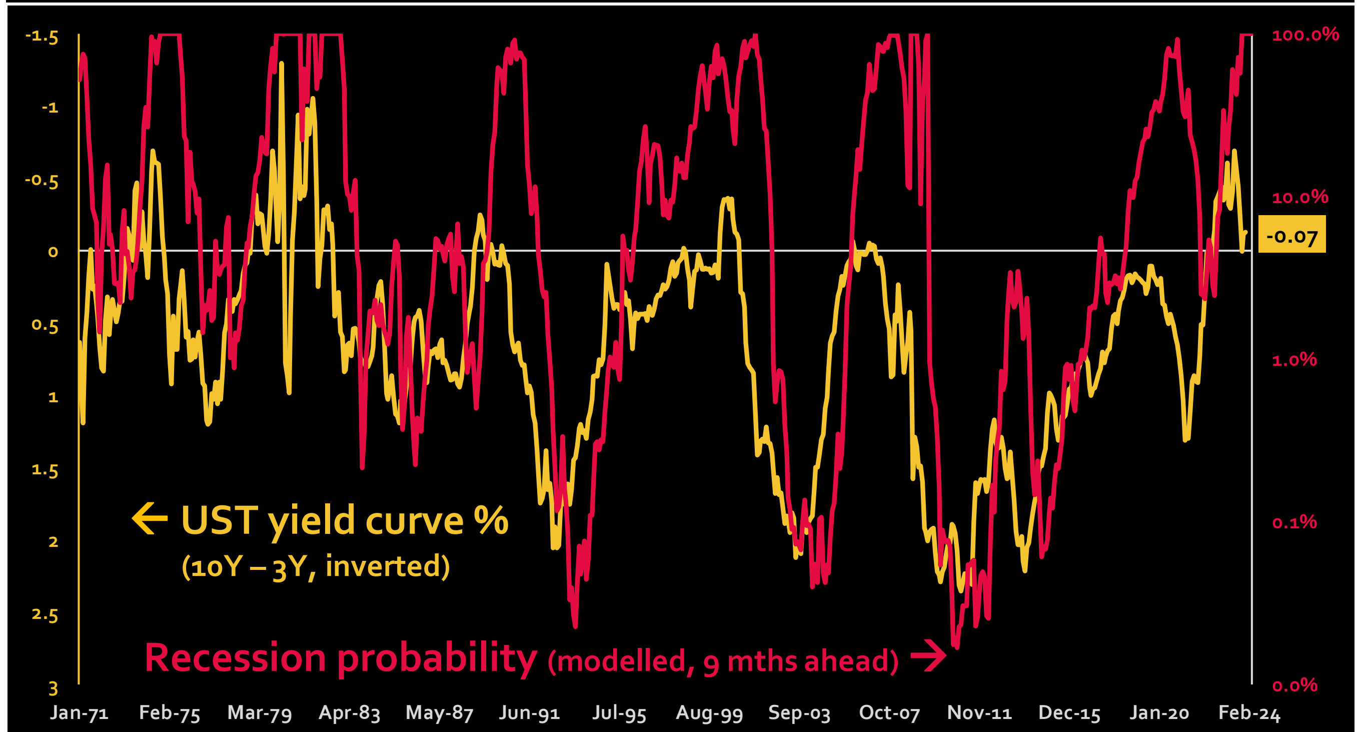
Source: US BLS, Bloomberg

Panel 3. The Fed's recent forecast illustrates the central bank's growing confidence in its ability to deliver the "soft landing" scenario



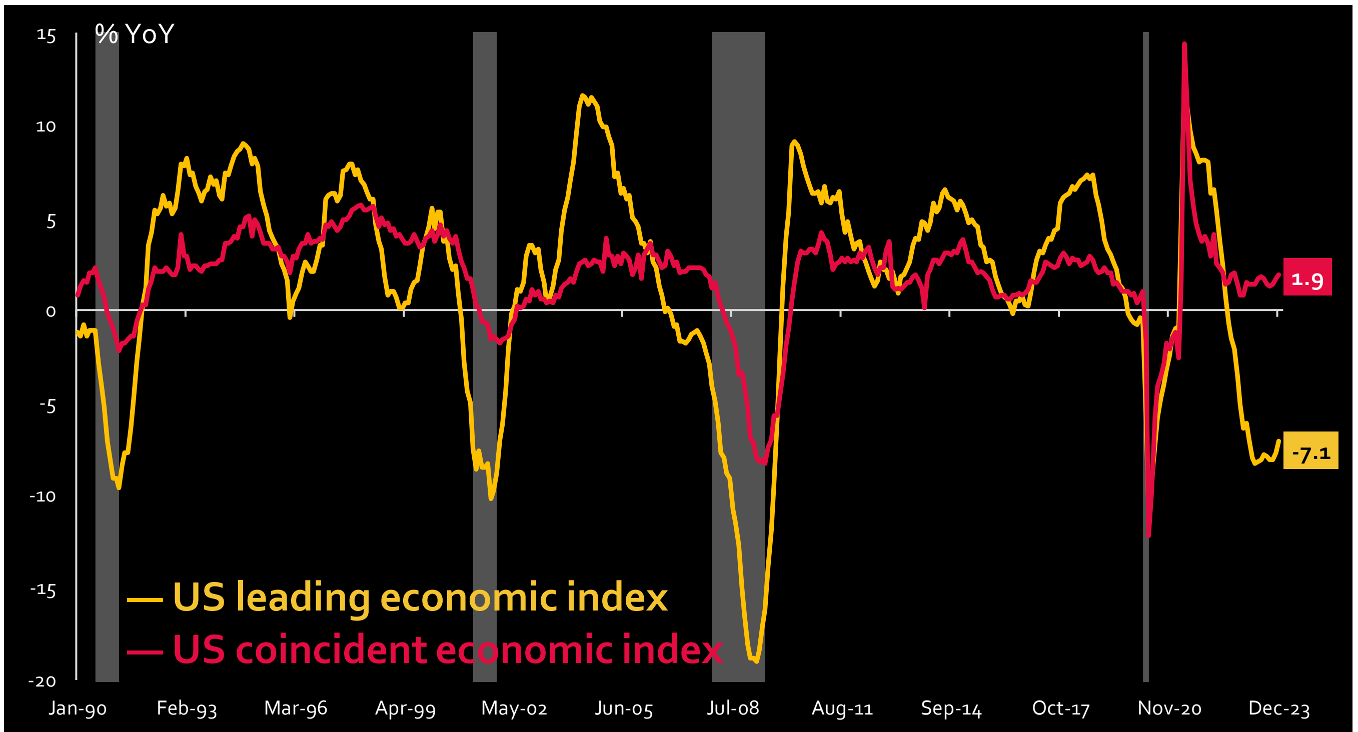
Source: Bloomberg, Federal Reserve

Panel 4. The inverted yield curve may be a product of higher T-bills issuance rather than weaker confidence in the US economic growth



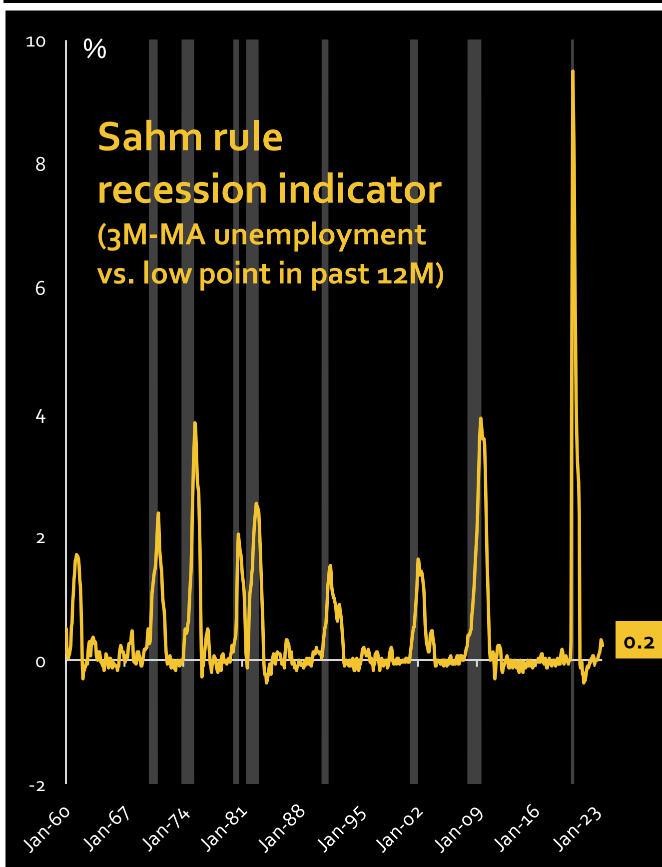
Source: Bloomberg, calculations by BCA Economist

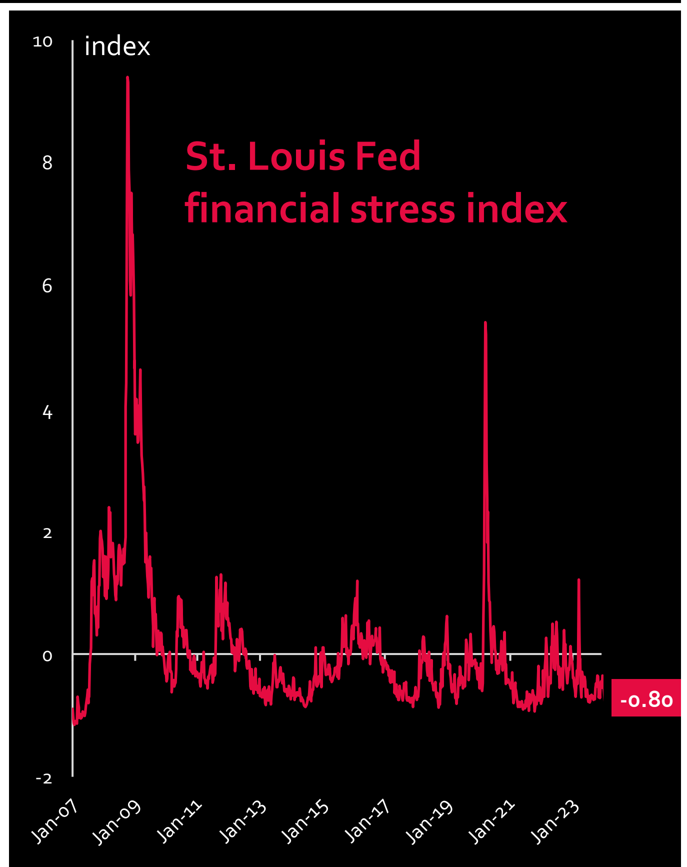
Panel 5. **US leading index remains near bottom, but recession still not in view**



Source: Conference Board

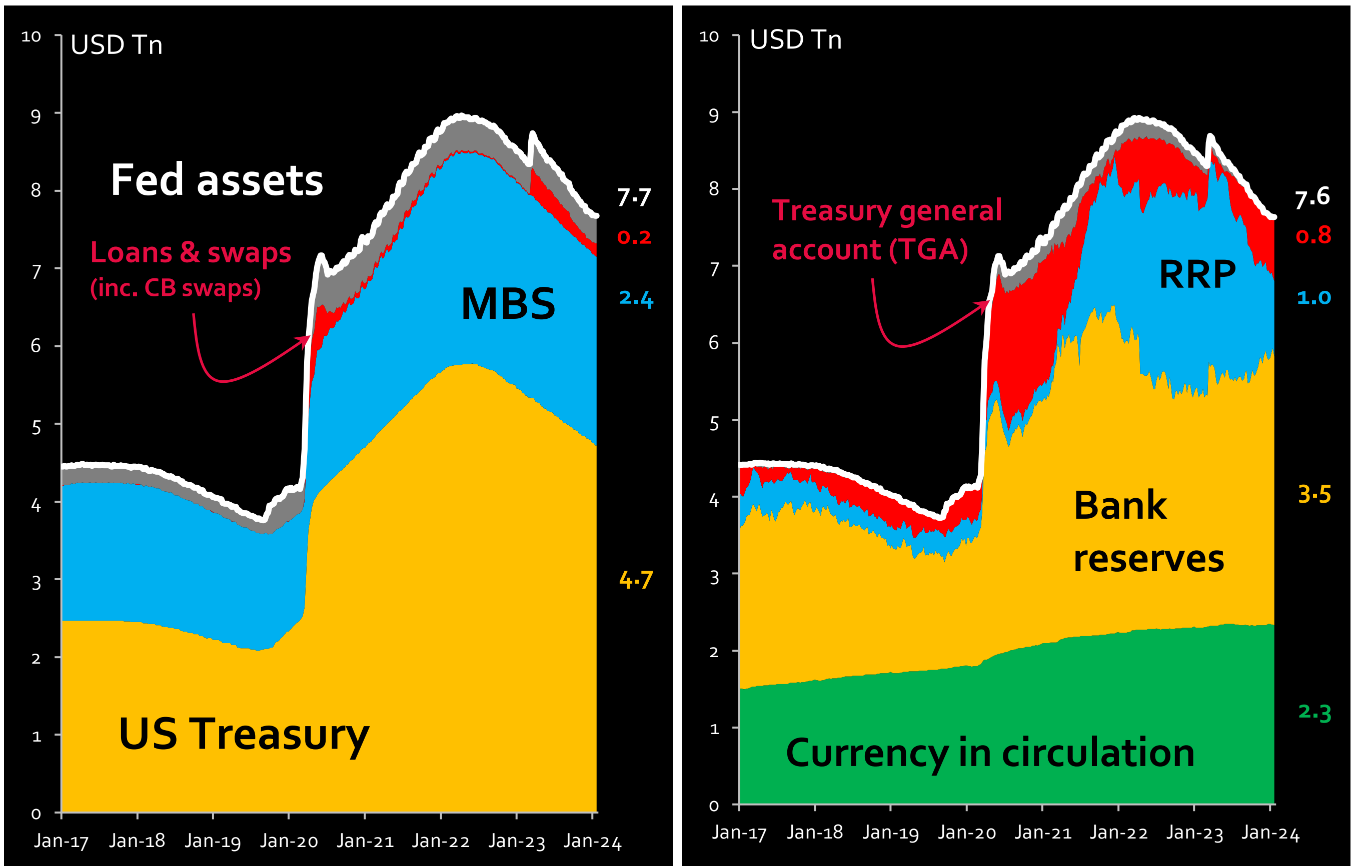
Panel 6. **Both on the real and financial sides, signs of impending US recession remain limited**





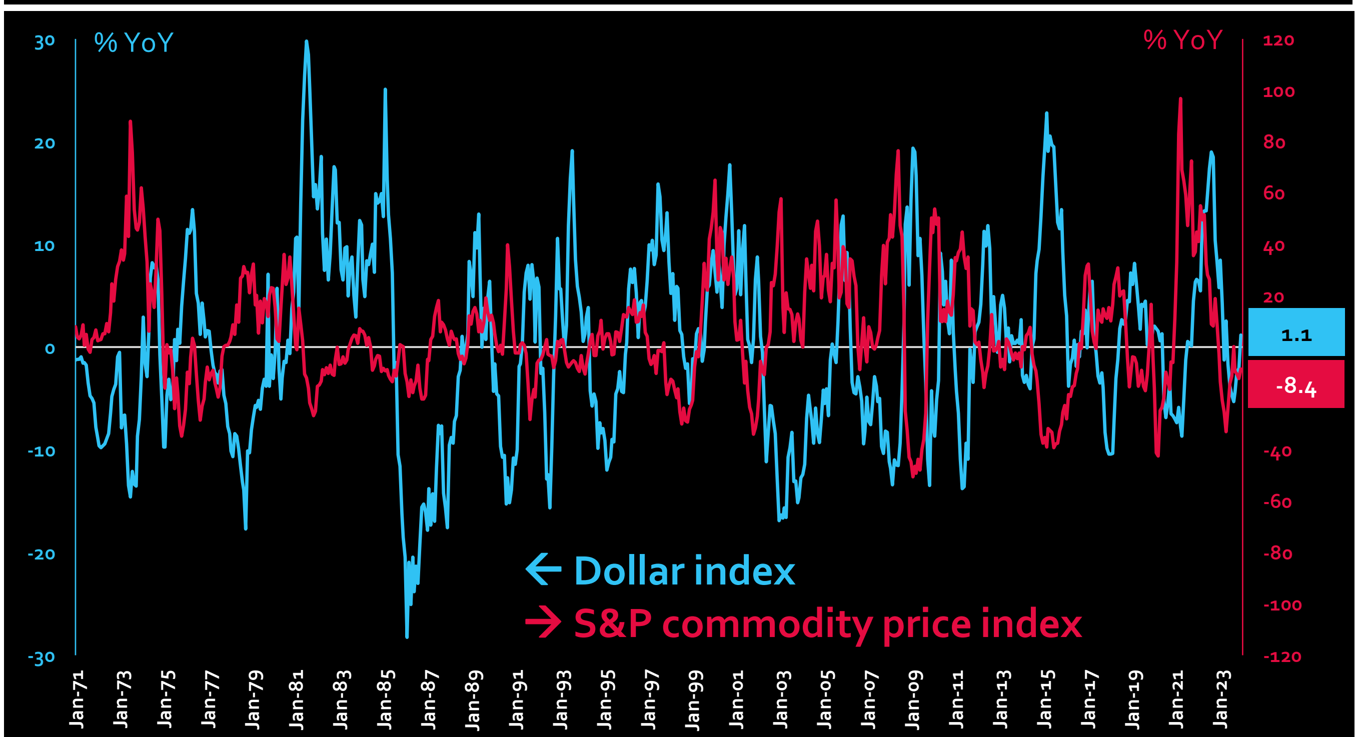
Source: St. Louis Fed

Panel 7. Declining bill issuance in the upcoming months could help replenish the RRP and allow the Fed to continue QT



Source: St. Louis Fed

Chart 1. USD back on the uptrend, a sign of tightening liquidity?



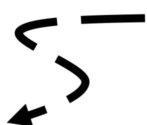
Source: Bloomberg

Selected Macroeconomic Indicator

Key Policy Rates	Rate (%)	Last Change	Real Rate (%)
US	5.50	Dec-23	2.10
UK	5.25	Dec-23	1.25
EU	4.50	Dec-23	1.70
Japan	-0.10	Jan-16	-2.70
China (lending)	2.50	Dec-23	4.65
Korea	3.50	Nov-23	0.30
India	6.50	Dec-23	0.81
Indonesia	6.00	Nov-23	3.43
Money Mkt Rates	**31-Jan**	**-1 mth**	**Chg (bps)**
SPN (1M)	5.88	5.80	7.6
SUN (10Y)	6.57	6.45	11.8
INDONIA (O/N, Rp)	5.81	5.88	-7.7
JIBOR 1M (Rp)	6.64	6.65	-1.1
Bank Rates (Rp)	**Nov**	**Oct**	**Chg (bps)**
Lending (WC)	8.91	9.05	-13.89
Deposit 1M	4.52	4.43	8.25
Savings	0.67	0.67	0.34
Currency/USD	**31-Jan**	**-1 mth**	**Chg (%)**
UK Pound	0.788	0.785	-0.34
Euro	0.924	0.906	-2.00
Japanese Yen	146.9	141.0	-4.00
Chinese RMB	7.169	7.100	-0.96
Indonesia Rupiah	15,780	15,397	-2.43
Capital Mkt	**31-Jan**	**-1 mth**	**Chg (%)**
JCI	7,207.9	7,272.8	-0.89
DJIA	38,150.3	37,689.5	1.22
FTSE	7,630.6	7,733.2	-1.33
Nikkei 225	36,286.7	33,464.2	8.43
Hang Seng	15,485.1	17,047.4	-9.16
Foreign portfolio ownership (Rp Tn)	**Dec**	**Nov**	**Chg (Rp Tn)**
Stock	3,226.3	3,136.1	90.27
Govt. Bond	841.0	833.9	7.17
Corp. Bond	10.6	11.2	-0.59

Trade & Commodities	31-Jan	-1 mth	Chg (%)
Baltic Dry Index	1,398.0	2,094.0	-33.2
S&P GSCI Index	555.1	535.6	3.6
Oil (Brent, $/brl)	81.7	77.0	6.1
Coal ($/MT)	118.1	132.0	-10.5
Gas ($/MMBtu)	2.19	2.58	-15.1
Gold ($/oz.)	2,039.5	2,063.0	-1.1
Copper ($/MT)	8,500.5	8,463.9	0.4
Nickel ($/MT)	16,013.0	16,375.0	-2.2
CPO ($/MT)	810.6	802.7	1.0
Rubber ($/kg)	1.52	1.53	-0.7
External Sector	**Dec**	**Nov**	**Chg (%)**
Export ($ bn)	22.41	22.00	1.89
Import ($ bn)	19.11	19.59	-2.45
Trade bal. ($ bn)	3.31	2.41	37.13
Central bank reserves ($ bn)*	146.4	138.1	6.01
Prompt Indicators	**Dec**	**Nov**	**Oct**
Consumer confidence index (CCI)	123.8	123.6	124.3
Car sales (%YoY)	-19.1	-7.5	-13.8
Motorcycle sales (%YoY)	-11.6	-2.8	-4.0
Manufacturing PMI	**Dec**	**Nov**	**Chg (bps)**
USA	47.4	46.7	70
Eurozone	44.4	44.2	20
Japan	47.9	48.3	-40
China	50.8	50.7	10
Korea	49.9	50.0	-10
Indonesia	52.2	51.7	50

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



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Indonesia – Economic Indicators Projection

	2019	2020	2021	2022	2023E	2024E
Gross Domestic Product (% YoY)	5.0	-2.1	3.7	5.3	5.1	5.0
GDP per Capita (US$)	4175	3912	4350	4784	4982	5149
Consumer Price Index Inflation (% YoY)	2.7	1.7	1.9	5.5	2.6*	3.2
BI 7 day Repo Rate (%)	5.00	3.75	3.50	5.50	6.00*	5.50
USD/IDR Exchange Rate (end of year)**	13,866	14,050	14,262	15,568	15,397*	16.037
Trade Balance (US$ billion)	-3.2	21.7	35.3	54.5	37.0*	32.6
Current Account Balance (% GDP)	-2.7	-0.4	0.3	1.0	0.1	-0.5

*Estimated number

** Estimation of Rupiah's fundamental exchange rate

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