

Special Report

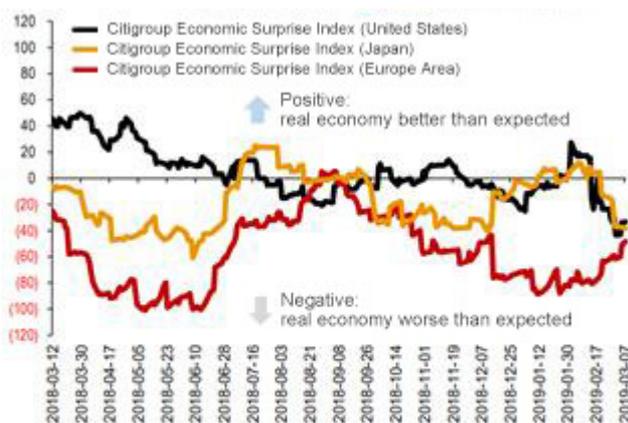
—Fed's Policy Shift Year

Part I:

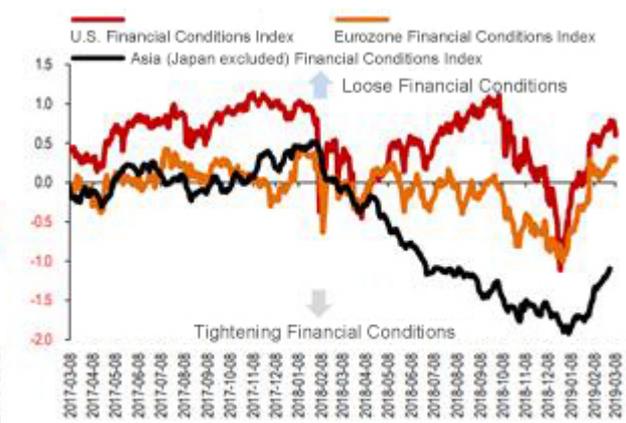
Why the shift in monetary policy

Prior to the beginning of 2019, America saw a quarter threatened by a growing crisis. On October 3, 2018, starting with Federal Reserve Board Chairman Powell's statement that "It is still a long way before the neutral interest rate," the collapse of the U.S. stock market led many stock indexes into technical bear market, and the assets such as Treasury inflation-protected securities and credit bonds in the U.S. were greatly depreciated. It was the same with global assets, including energy.

Meanwhile, the U.S. and global economies suffered a rapid downturn in the fourth quarter, as evidenced by the stalled industrial expansion, the cooling of inflation and a new low in business confidence. The Citigroup's global economic surprise index (CESI), which reflects the difference between the actual economic data released and the market expectation, turned downward, and the CESI dropped below the zero axis with respect to the United States, the Eurozone and Japan.



Source: wind, Huatai Securities Research Institute



Source: Bloomberg, Huatai Securities Research Institute

Given such a backdrop, the decision makers of the Fed began to gradually change the tone. By the end of December 2018, the U.S. government was in the midst of its longest shutdown in its history, delaying the release of several key aspects of data. The Fed was caught in a dilemma, while the policy makers were

becoming increasingly dovish in their belief that the economy was weakening.

In the statement after the first FOMC in 2019, the Fed deleted "gradual increase in interest rates" and "roughly balanced risks facing the economic prospect," admitting that "market-based expectations of inflation fell," downgraded its judgment of the U.S. economy from "robust growth" to "steady growth," and rarely added three sections of words about shrinkage.

The postponement of key data offered the strongest endorsement of the Fed's dovish shift:

1) Retail sales data, which reflect the strength and weakness of consumer spending, which accounts for more than 70% of U.S. economic output, suffered a historical weakening. In December of 2018, the U.S. saw its retail sales fall 1.6% month-on-month, the biggest drop since September 2009. Moreover, core retail sales fell 1.8%, the biggest drop since September 2001.

2) The U.S. saw its trade deficit reach \$59.8 billion in December, a figure that outstripped the expectations. Given inflation, this level of deficit represented the biggest drag on GDP over the same period since the founding of the United States. The IMF expected the U.S. current account deficit to expand 26.4% year-on-year in 2019, with annual growth hitting its post-2000 peak.

3) The U.S. government's 1.5 trillion tax reform policy has shown an increasingly clear marginal diminishing effect. The 2.2% annualized quarter-on-quarter growth rate of its GDP in the fourth quarter of 2018 was significantly slower than that in the third quarter.

Real GDP: Percent change from preceding quarter



U.S. Bureau of Economic Analysis

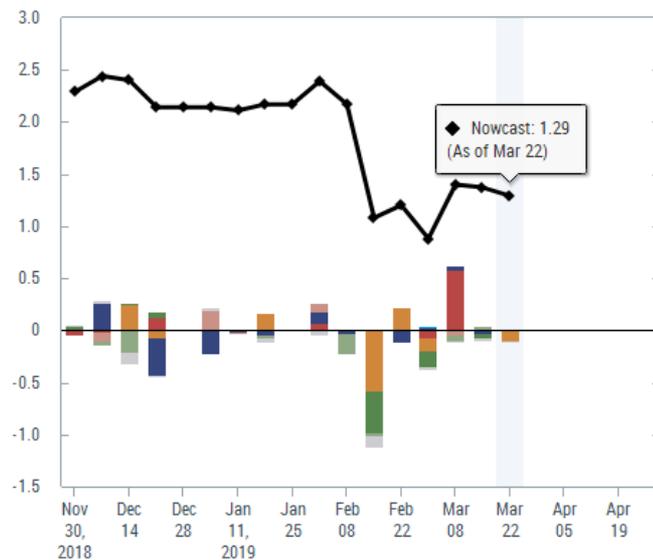
Seasonally adjusted at annual rates

Trade and retail sales data represent a low trajectory for the U.S. economy in the first quarter of 2019, some agencies said. Forecasts for U.S. growth in the first quarter of 2019 were pessimistic, according to prediction models such as Atlanta Fed's GDPNowcast model based on Bridge-equation integration source data and corresponding GDP subcomponents, the GDPNowcast model of the New York Fed based on Kalman filter technology and dynamic factor modeling, and the "Eight Immortals Crossing the Sea" prediction model of investment banking institutions. As of March 22, the median forecast from the leading investment banks was 1.5%, and the two Fed models were even gloomier (1.29% for the New York Fed and 1.2% for the Atlanta Fed).

◆ The New York Fed Staff Nowcast ○ Advance GDP estimate □ Latest GDP estimate

■ Housing and construction ■ Manufacturing ■ Surveys ■ Retail and consumption ■ Income ■ Labor ■ International trade ■ Others

Percent (annual rate)



Source: Authors' calculations, based on data accessed through Haver Analytics.

Collapse

Data Flow (Nov 30, 2018 - Mar 22, 2019)

Model Update	Release Date	Data Series	Actual	Impact	Nowcast GDP Growth
					1.29
Mar 22	10:00AM Mar 22	Merchant wholesalers: Total inventories	1.18	-0.09	1.29
	8:30AM Mar 21	Philadelphia Fed Mfg. Business Outlook: Current activity	13.70	0.01	
		Data revisions		-0.01	
					1.37
Mar 15	10:00AM Mar 15	JOLTS: Total job openings	102.00	-0.00	1.37
	9:20AM Mar 15	Capacity utilization	-0.03	-0.02	
	9:20AM Mar 15	Industrial production index	0.15	0.02	
	8:30AM Mar 15	Empire State Mfg. Survey: General business conditions	3.70	-0.02	
	10:00AM Mar 14	New single-family houses sold	-6.90	-0.04	
	8:30AM Mar 14	Export price index	0.64	0.03	
	8:30AM Mar 14	Import price index	0.56	0.01	
	10:00AM Mar 13	Value of construction put in place	1.31	0.04	

Part II

Reality not as silky as ideal

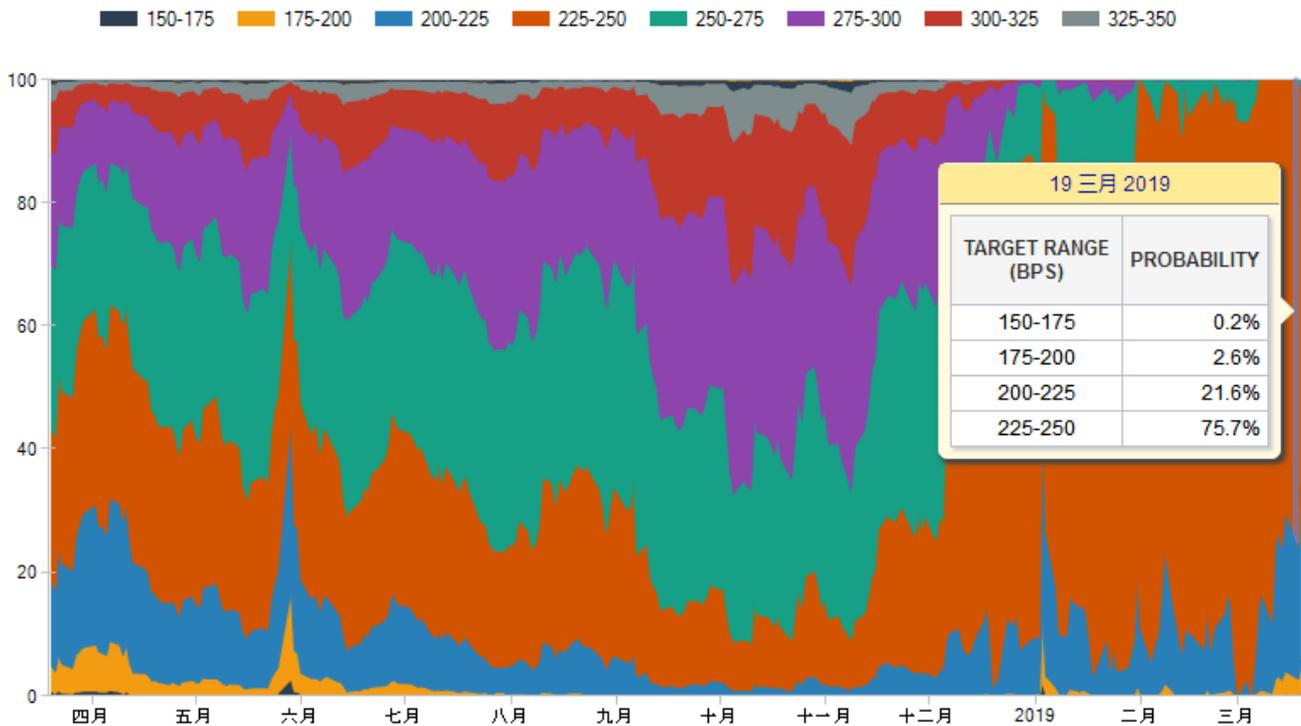
As early as the end of 2018, there was sign that the Fed was shifting to dovish monetary policy. Fed Chairman Powell said, in a speech at the end of November 2018, that interest rates were "just below" the neutral range, as opposed to a former statement that "it is a long way before the neutral interest rates." The subtle changes in his rhetoric, however, elevated concern in the market. Institutional investment banks almost immediately recognized that the Fed's tightening monetary policy was coming to an end. At that time, the prevailing view among institutional analysts was that the Fed would raise rates two more times in 2019 following the one in December 2018, and that this would mark the end of the interest-rate rise cycle.

The truth, however, is that reality can never be as silky as ideal.

Since January 2019, almost all of the Fed's policymakers have given speeches or published papers that were more cautious and dovish than their original positions. Among them there are former New York Federal Reserve Bank President Williams, who previously was a monetary hawk, advocating that "slowdown is the new normal, and QE and negative interest rates will be considered if necessary"; Cleveland Federal Reserve Bank President Mester, whose argument was that "if inflation doesn't pick up, the Fed could stop raising interest rates this year," and Boston Federal Reserve Bank President Rosengren, who said, "Whether more rate hikes are needed depends on the economy."

Market expectations of the number of the Fed's rate hikes for this year and next have cooled sharply. A look at the probability charts reflected by the CME FedWatch tool shows that the market had all but downplayed the likelihood of a Fed rate hike in 2019 on the eve of the Fed's March meeting. The boldest analysts even pointed out that the Fed's next move would not be a rate hike but would instead be a cut.

Target Rate Probability History for Federal Reserve Meeting on 11 十二月 2019



Source : CME Group

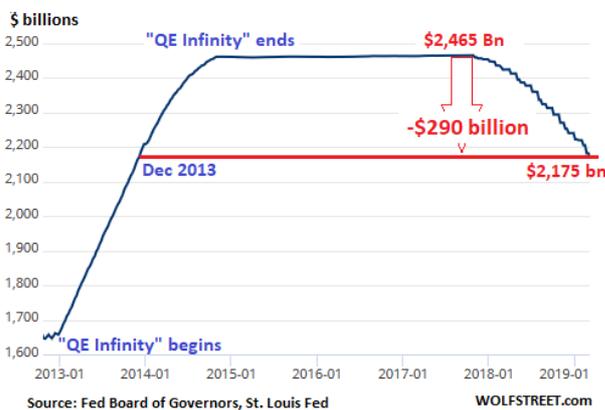
Expectation of an interest rate cut may sound like aggressive speculation, but the suspension of interest rate increases has become a consensus among the Fed and the market. At the Fed's March meeting, policymakers firmly put the brakes on tightening. Most fed officials expected the number of rate hikes to fall from two to zero in 2019 and at most once in 2020. They lowered GDP and inflation expectations for this year and next, and raised unemployment expectations. Thus, a plan was made to halve the scale of Treasury bond reduction from May 2019 to the end of September, and plans were made to continue reducing its holdings of agency bonds and mortgage-backed securities (MBS) so as to align with its long-term goal of primarily owning U.S. bonds.

The threshold for dovish modification of the Fed funds rate is undoubtedly

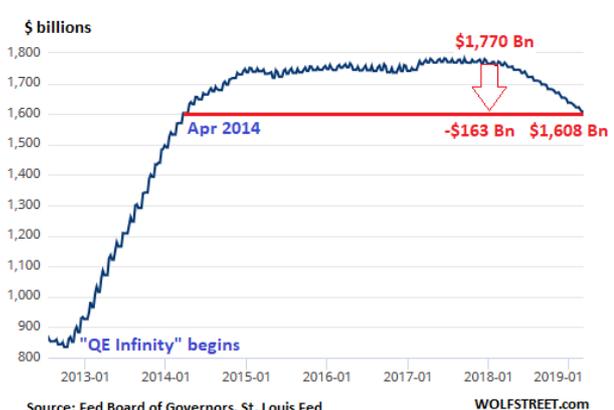
higher than that of the conventional monetary policy instrument, and the signal of a shift in monetary policy is stronger.

By the time QE stopped at the end of 2014, the Fed's balance sheet had reached a frightening \$4.5 trillion. According to the Fed's balance sheet released on March 7, 2019, Fed had cut \$290 billion in Treasury bonds, \$163 billion in MBS and \$48 billion in other assets since October 2017, when its downsizing was rolled out. Such asset reductions are unprecedented in its history.

QE Unwind at Work
Federal Reserve, Treasury Securities



QE Unwind at Work
Federal Reserve, Mortgage-Backed Securities



The Fed's position is clearly one in which it will end its 24-month balance-sheet "squeeze plans" at the end of the third quarter. Certainly, this represents an early time node in all the mainstream market expectations. The result, in other words, is that the Fed's balance sheet will be "fuller" than previously expected.

Part III

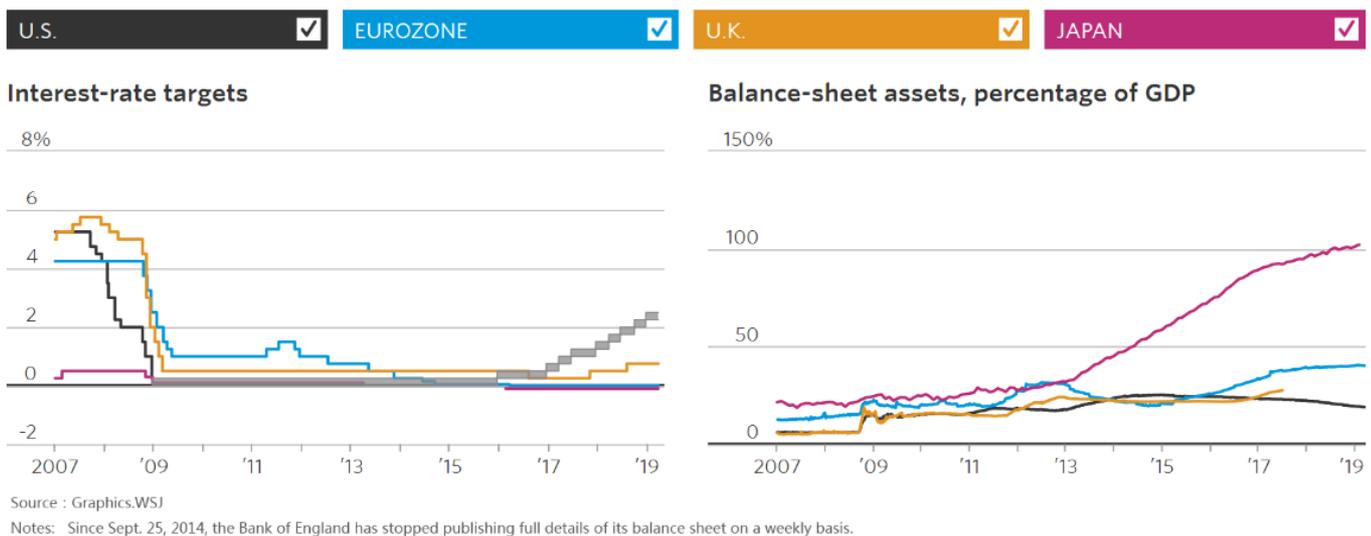
Impact on foreign currency market of the Fed's policy shift

It is a fact that the Fed has entered the end of its tightening cycle. However, in currency markets, even after the March meeting in which dovishness prevailed, the demand for the dollar dropped sharply on the second day.

The main reasons for this phenomenon are the expected repair and peer foils:

Expected repairs: The Fed's plan to keep the size of its balance sheet "above pre-crisis levels" was not a decision made in 2019. The document "Policy Normalization Principles and Plans," published in September 2014, and the supplemented document released in June 2017 stated, "The Fed's reserve balance will eventually be higher than before the crisis." Prior to the March meeting, several senior officials of the Fed gave speeches to inform the market to a certain extent. As a result, on the eve of the March meeting, a number of institutions expected the Fed to release details of changes to the size of its contraction, although most of them failed to expect the pause to be the end of the third quarter. In other words, there is no "reversal" in market expectations of the Fed's monetary policy. Market pricing only needs some adjustments and repairs.

Peer foil: As of March 2019, the size of the Fed's balance sheet as a percentage of the U.S. GDP has dropped to 19.0% from its peak of 25.3% in December 2014, well below the Eurozone's 40.4%, and far lower than the Bank of Japan in the pursuit of its easing policy, in which the balance sheet now stands at 102.2% of GDP. Additionally, the Fed started to raise interest rates at the end of 2015. By March 2018 it had raised interest rates nine times, totaling 225 BPS, leaving other central banks far behind.





It is now more than ten years since the financial crisis, and central banks around the world have come to the point where their monetary policy is to be changed, including the BOJ, which has followed an easing policy alone; the ECB, which has drawn up plans for a new round of TLTRO; the Bank of England, which is caught in the Brexit whirlpool; the RBA, which has explicitly opened its options for a rate cut; and the Bank of Canada, which has been described as "practically surrendered." The Fed has certainly gone farther than other major central banks in its post-crisis normalization of monetary policy, a move that was strongly supported by the relatively stronger fundamentals of the U.S. economy. Thus, the dollar continues to be attractive at the end of the Fed's tightening cycle.

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