Mizuho Chart Speak: Fed & EM Asia

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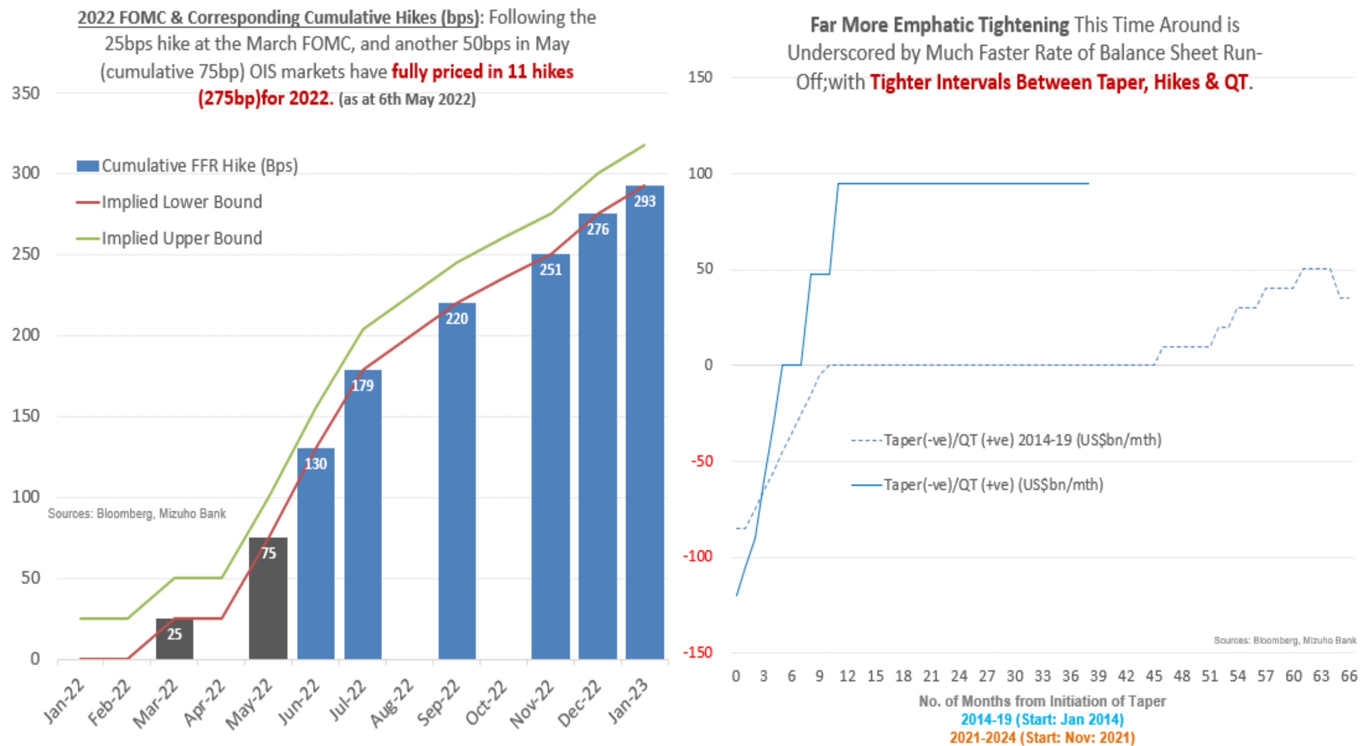
Economics & Strategy | Asia ex-Japan

May 6, 2022 | Vishnu Varathan | Head, Economics & Strategy

The Fed's Tightening: Re-arranging the Deck Chairs on the Titanic



Dovish Interpretations Misguided: **Any attempt at a dovish interpretation of the Fed is merely rearranging the deck chairs on the Titanic**. This is validated **by the brutal, "morning after" sell-off** (5th May) on Wall St that more than wiped out post-FOMC (4th May) gains; as earlier *relief that the Fed is not actively considering 75bps hikes proved egregiously misguided.*

The bigger and more accurate picture is one of an **unwaveringly and aggressively hawkish Fed; with attendant risks of economic and asset market turbulence in tow**. **Accompanied by a stronger USD**, especially insofar it is driven by the confluence of *rapidly rising US rates* amid rate hikes and *tightening USD supply* from QT, the **reverberations from the Fed's tightening may be most acute in EMs**. Accordingly, downside volatility in EM Asia FX could easily persist into Q3 despite rate hikes being mostly baked in.

Policy Hijacked by Inflation: Fact is, with Fed's initial "transitory" inflation prognosis caught spectacularly wrong-footed, **fears of more profound, pervasive and persistent inflation have hijacked the Fed's policy agenda**; as geopolitical price shocks and rolling supply-chain disruptions compound pre-existing cost-push.

Consequent Severe Tightening: Consequently, the **Fed,** which is consumed by an urgency to get inflation under control, **is poised for the most severe tightening cycle in recent memory**. The **intensity of** this **tightening cycle** may be under-appreciated unless the *amplitude, pace* and *combination* of tightening tools (both rate hikes and QT) are considered holistically. And the sense is that the **whole (tightening impact) may be greater than the sum of the parts**, which are comprised of;

i) an aggressive rate hike cycle (of a cumulative 275-300bps of rate hikes into early-2023, possibly more beyond) that is **likely engineered to overshoot "neutral rates"** to anchor inflation expectations alongside;

ii) fairly harsh balance sheet run-off (also known as quantitative tightening, abbreviated as QT), which is **set to drain a staggering $522bn from global markets in 2022** and almost **$1trln in the first 12months starting June 2022**.

Greater & Faster: Crucially, **not only is the amplitude of tightening greater**, but the **pace is significantly faster**. In the **2014-19 tightening cycle** the **total quantum of rate hikes was 225bp**, **spread over 5 years** (from the start of "taper"). Whereas **this time**, the Fed is **primed to hike by 225bp** (as per OIS pricing) **within the first 12 months; and potentially by 350bps or more** beyond.

Similarly, **QT in the last tightening cycle was phased in only 45 months from taper**; and very gradually stepped up (from $10bn/mth) to a *$50bn monthly reduction.* **This time**, QT kicks off **just eight months after taper**; *at $47.5bn for the first three months and at $95bn thereafter.* In the **first 12 months**, QT this time **will drain $1trln** from the global financial system **compared to $230bn in the last cycle**.

Roughly speaking **both rate hikes and QT may be five times as impactful in amplitude and/or pace**. And the main impact may be from both being delivered simultaneously!

Hikes-QT "Double Whammy": This **double-whammy of rising price** (from rate hikes), **and reduced supply** (QT), **of money** (USD) inadvertently **risks hitting the economic brakes hard**; **especially being delivered insignificantly stronger dosages over a much shorter duration**.

Specifically, the outsized tightening impact may be owed to more **burdensome debt servicing** (flows impact) burdensome and **asset price pressures** (balance sheet effect) *feeding off, and into, one another.*

Fed Hawks & USD Bulls: With an **aggressively hawkish Fed feeding off wage-price spiral risks** amid an exceptionally tight job market, global policy divergence, rather than a flip to policy convergence, is likely to entrench in coming months. In turn this is likely to **underpin resultant USD strength alongside rising UST yields**. What's more, **apart from the yield-driven boost to the USD**, there could be a **more pronounced and persistent USD dominance** insofar that global USD liquidity drainage is set to be stepped up in Q3.

Fed Hawks & EM Bears: The confluence of rising US interest rates, with shrinking USD liquidity and a stronger USD are **notorious for compounding economic and asset market pain** from the Fed's tightening; which is cruelly **likely to be felt more acutely outside of the US**, and in particular in EMs.

Especially with **knock-on impact from adverse feedback loops** from the double whammy of rising costs of debt and falling values of assets. Against this backdrop, **volatility is par for the course**. Some **risk of reflexivity** causing **sharp, pain in EM Asia FX being prolonged into Q3** at least; especially as aggressive rate hikes and sizable USD liquidity drainage conspire.

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