QT to QE

- **Fed turns on quantitative easing for first time since 2016 – US government bond recovery continues**
- **Fed indicates some reluctance to cut rates further – the market disagrees**
- **Surprise cut in corporation taxes positive for Indian equities**
- **UK edges forward on Brexit negotiations**
- **Sterling strengthens…could the equity market follow?**

Bonds are back in the ascendency - the Fed has finally relented. Quantitative tightening (QT) has become quantitative easing (QE). The change of direction came last week after the repo market hit trouble. The Fed was forced to intervene and expand its balance sheet for the first time in 2016 with an initial injection of $75bn of liquidity. The Fed's QE contrasts with the signal it sent to the markets that it is not willing to endorse the view that further interest rate cuts are warranted.

Last week the repo market showed the kind of stress last seen in the World Financial Crisis. The overnight Treasury repo rate spiked to 10% on Tuesday against a recent benchmark of around 2%. It was worrying that the repo market problems occurred at a time when there is no clear evidence of marked economic stress. The issue may have been that The New York Fed at the centre of the repo market simply miscalculated the situation. Many commentators pointed to the "inexperienced" leadership of the NY Fed. Also, the problem was exacerbated by seasonality. Companies are paying tax bills, so they are pulling cash out of the money market funds. Either way the QE window is open again.

Fed action is likely to continue to be supportive of US government bonds and dollar credit. Whichever way you look at it, the Fed has been forced back into QE. Such Fed action supports lower US government bond yields. The US 10-year government bond yield that recently peaked at 1.90% is back down close to 1.70%.

While the Fed was fighting fires, the FOMC policy rate committee was showing a marked reluctance to endorse the market's view that the US economy needed further interest rate cuts beyond last week's 25bps cut to the range of 1.75%-2.00%. The so called 'dot plots' showed that the Fed governors collectively believed there would be no need for further rate cuts through to the end of next year. Indeed, two Fed presidents voted against the cut, although Jim Bullard argued for a larger reduction.

In the wake of the meeting the market has modified its view of future rate cuts. At one stage the market priced that rates could fall to as low as 1% by the end of next year. Today, the market is still hopeful of two further cuts by the end of next year. We suspect much will depend on the outcome of the trade talks in October. The Fed's own researchers have concluded that the trade wars could reduce US economic growth by as much as one percentage point. The committee must be betting that the US and China will see to eye-to-eye at their meeting in October and that the trade war risk will abate. If there is a bad outcome from the talks the Fed may have to alter its view.

The Fed is right in one regard, the US economy at this exact moment does not look like it needs a significant boost from policy easing. Recent economic data has mostly come in ahead of expectations. The Citigroup economic surprise index, which measures the degree to which economic data is above or below expectations, has risen to 40 on a scale of -100 to +100. At the beginning of July, it was down at -60.

India back on the front foot

Are better times back in the Indian equity market? The Indian asset markets, after some tough months, finally got a shot in the arm. Early last week, the Reserve Bank of India signalled that they were prepared to cut interest rates still further. Additionally, the Indian finance minister Nirmala Sitharaman lowered the base corporate tax for existing companies to 22% from the current 30%. For new manufacturing firms incorporated after October 1, 2019, and starting operations before March 31, 2023, the rate was cut from 25% to 15%.

India had good need to cut corporate taxes. Indian corporate taxes were well above global norms. The cut in corporate tax brings Indian corporation tax rates closer to the global average of 23.8% and the Asian average of 21.1%. Also, Asian countries are clearly trying to take advantage of the problems in China. For example, last week Thailand cut its corporate rate tax to 10% of the factories that relocate from China. Vietnam's corporate tax rate of 20% for new manufacturing companies compares with the new rate in India of 15%. Analysts believe that the Nifty could now see earnings growth of 25% in the financial year 2020.

Earlier in the week the governor of the Reserve bank of India, Shaktikanta Das said that there was room for further interest rate cuts to support economic growth. Indian inflation has been well-behaved of late giving the policymaking committee scope to cut rates. Given that economists' forecasts for growth have been coming the MPC probably has the scope to cut rates by a further 1 to 2 percentage points over course of 12 months. Although the rupee has been under some pressure against the dollar, India's current-account deficit at 1.4% of GDP and the relatively high foreign-exchange reserves of dollar $429 billion probably provides sufficient cover for the Reserve Bank to be moderately aggressive in cutting interest rates.

Indian equities rallied by 5.3% last Friday but probably have more upside in the near term. Market participants will be hoping the Sensex can get back to its high of June. Ironically at Thursday night's close, the index was down 10% from its highs. The day's rally represented the largest increase in the index since May 2009. Auto stocks and HDFC bank, who are high taxpayers, were up as much as 10%. There could be more buying in the near term; international asset managers have sold $4.9 billion of Indian equities since June in fear of the ongoing weakness in the economy. That represented the largest net sale of equities since 2016. The medium-term returns are less assured as the market trades on a relatively high valuation. That said, if the structural reforms can have traction and cuts in interest rates can spur higher confidence and a re-acceleration of growth, then the market could be set to rise a further 10-15%. The emerging market equity index lacks good stories at the moment, India could see more than its fair share of capital flows.

UK edging forward

Here we go again in the UK. The media scrum is focused on the Supreme Court judgement. The outcome may have significant constitutional implications, however the impact on Brexit may be limited. The UK-EU negotiations are focused on the need to construct a Northern Ireland-only set of trade relations with the EU (and the Republic) that eliminates the need for a backstop covering the whole UK. Different sides of the argument are showing some flexibility which has given hope for a deal; the Democratic Unionist Party appear more willing to compromise given the potential damage of No-Deal to the province. Concrete proposals from the UK don’t look likely until after the political party conference season ends on October 2nd.

Meanwhile, the Bank of England's Monetary Policy Committee grows more cautious as reflected in the minutes of its last meeting held on September 18. The committee accepted that “underlying growth has slowed, but remains slightly positive, and that a degree of excess supply appears to have opened up within companies… Brexit uncertainties have continued to weigh on business investment although consumption .. remained resilient…the weaker global backdrop is weighing on exports.” It explicitly referenced the increase in government spending that “could raise GDP by around 0.4% over the forecast time-horizon (of the MPC), all else equal.” Like everyone else, the committee is watching what emerges on Brexit by the end of October. Notwithstanding the emphasis on a 'balanced response', if political uncertainties cause economic stress, the committee is biased to then join the international easing trend despite a tight labour market and accelerating wage growth.

Whatever your political view point the UK and EU do appear to have moved closer to an agreement even if the chasm between the two sides is still wide. Sterling’s recovery to $1.24 is evidence of a better mood. We note that the

UK equity market on a 5% yield and at the lowest price relative to the global index since the 1970's, must at some stage become attractive to global investors.

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