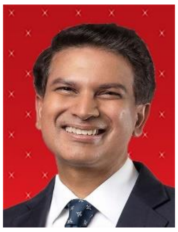
Macro Insights Weekly
"Melt-up risks"

Group Research November 25, 2024



Taimur Baig
Chief Economist
taimurbaig@dbs.com

Ma Tieying
Senior Economist
matieying@dbs.com

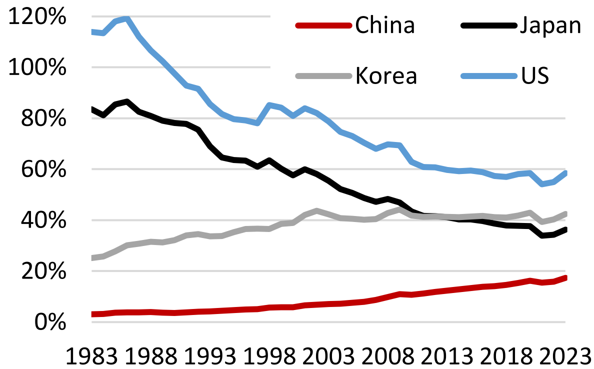
For Alliance Bank clients, please direct your enquiries to Malaysia Research +603 2604 3915 general@alliancedbs.com

- *The fact that those likely to benefit from Donald Trump's policy measures have rallied since November 5 is unsurprising. Outsized gains however could set the ground for a disruptive correction.*
- *Parts of US financial markets, already rich by historical standards, are facing "melt up" risks.*
- *This is driven by a mix of exuberance, liquidity, and a plethora of products to play the markets.*
- *Crypto and leveraged tech ETFs are the flavours of the moment.*
- *Meanwhile, the fixed income market is worried about inflation and fiscal risks.*
- *Short-term market frenzy could set the ground for a disruptive sell-off.*

Chart of the Week: Measuring prosperity

Singapore's journey over the past four decades can be seen through the eyes of other economies. Setting Singapore's per capita income to 100, the relative rise of China and Korea looks promising, while the backslide of the US and Japan is striking. That Singaporeans have seen their real purchasing power rise by around 470% in the last four decades is most impressive. Many challenges remain, but they don't diminish the city state's achievements.

Gross domestic product per capita, constant prices
Purchasing power parity; 2017 international dollar, **% of Singapore**



Source: IMF WEO Oct 2024, DBS

Commentary: “Melt-up” risks

The following asset price movements since the 5th of November characterise the post-US election market reactions:

DXY	+4%
Gold	-1%
Bitcoin	+44%
Tesla	+40%
Nasdaq	+2.7%
CSI300 (China)	-6.3%

The fact that companies and asset classes that will likely benefit from Donald Trump’s policy measures have rallied and vice versa is unsurprising. The 40%+ rally of the likes of Bitcoin and Tesla however should warrant caution. We think that between deregulation and tax cut expectations, parts of US financial markets, already rich by historical standards, are facing “melt up” risks. This could complicate macro policies next year, setting the ground for a major market correction.

How does “melt up” transpire? It is a heady mix of exuberance, liquidity, and a plethora of products to play the markets. Crypto assets have been trading in the exchange traded fund markets this year, offering intraday liquidity and easy entry/exit. We are also monitoring the proliferation of highly leveraged exchange traded funds that track the stock of tech companies, the amount of daily trading in which is approaching USD100bn. These trades are not restricted to small-time day traders; large institutional investors and high net worth individuals are deeply engaged as well. There is a degree of the old “as long as the music is playing, you've got to get up and dance” phenomenon in the making; no one wants to be left behind in a rally of historic proportions.

Is there a build-up of systemic risks? Regulators don’t seem to think so, taking solace from tight labour markets, strong wage growth, and sound corporate/household balance sheets. But such complacency should be seen in the context of the several financial market crashes in this century being missed by the early warning models of financial market stress.

What could be the trigger? It has to be the Fed and interest rates, in our view. The melt-up dynamic, if it spills into January, would raise serious questions about the inflation outlook and financial stability. Even if policy makers don’t flag the latter publicly, a number of market participants will begin to hedge against that possibility. Already, the treasury curve have rotated up considerably this month, showing rising discomfort about the inflation and fiscal outlook. Combine this with the relentless rise in asset prices, and the likely policy volatility that may ensue after January 20, we are inclined to see the current good times with some trepidation.

A key follow-up question is what would all this mean for emerging market economies. Our key concern right now is the FX space, where the current USD rally becomes a disruptive one in the lead-up to late January as tariffs are announced. We don’t think key EM central banks would try to fight the USD by intervening heavily, which would mean room for further depreciation of EMFX. Once the inevitable US market correction comes, there will be room for regional stocks and currencies to rally, but expect plenty of vols before that.

Taimur Baig

FX: Profit-taking in Thanksgiving week

The Trump Trade has lifted the DXY Index by 6.7% since September 30, divided between 3.4% this month and 3.2% in October. US President-elect Donald Trump has nominated China hawks to key positions in his upcoming administration, strengthening conviction for tariffs to be implemented soon after his inauguration on January 20, 2025. During his presidential campaign, Trump proposed a 60% tariff on Chinese goods and a universal tariff of 10% on all imports. Believing that tariffs are inflationary, the futures market sees the Fed Funds Rate declining less to 4% by the end of 2025 vs. 3% in September. This week's PCE inflation data will unlikely deter the Fed from lowering rates by 25 bps to 4.25-4.50% on December 18.

However, **some players will be tempted to book profits on hefty gains ahead of the long Thanksgiving weekend.** During the greenback's Trump-led rally in 2016, DXY corrected lower by 1.6% after its 6.5% surge between the end of 3Q16 and Thanksgiving.

Over the weekend, Trump nominated hedge fund manager Scott Bessent as Treasury Secretary, who advocated a measured approach to tariffs, more as a negotiation tool rather than widespread implementation. Bessent favours reducing the fiscal deficit through spending cuts to support extending Trump's 2017 tax cuts. Bessent could also advocate increased oversight and reforms at the Fed to align it with the administration's objectives.

The US Senate also demonstrated that its tolerance for Trumpism has its limits. Trump nominated Pam Bondi as Attorney General after Matt Gaetz withdrew because of federal investigations into allegations of misconduct and ethical violations. Some of Trump's other cabinet nominations may encounter opposition during the Senate confirmation process for their lack of experience or controversial views and stances on significant issues.

Fears increased that the Ukraine-Russia war has escalated involving NATO. Moscow deployed advanced missiles into Ukraine after lowering its threshold for the use of nuclear weapons. It also threatened to target military facilities in the UK and the US for providing Ukraine with the missiles that struck Russia.

NZD/USD has depreciated 8.1% since the end of September to 0.5833 last Friday. Markets have fully priced in a back-to-back 50 bps rate cut to 4.25% on November 27, when the Reserve Bank of New Zealand holds its final meeting for the year. CPI inflation fell from 3.3% YoY in 2Q24 to 2.2% in 3Q24, near the mid-point of the official 1-3% target range. Earlier this month, RBNZ warned that the domestic economy was weak from rising joblessness creating financial difficulties for some households. Businesses also delayed investment plans because of lower profitability from weak demand and lingering cost pressures. However, **NZD/USD could find support at October 2023's low of 0.58 if the RBNZ pushes back the market's bet for a third 50 bps cut** at its next meeting in February. The RBNZ reported that 2-year inflation expectations for 4Q24 rose to 2.12% from 2.03% in 3Q24, while 1-year expectations fell to 2.05% from 2.4%. RBNZ officials noted that Trump's pledge to impose universal tariffs on US imports could renew inflation and reduce the Fed's willingness to lower rates.

Philip Wee

Group Research

Economics & Strategy

Taimur BAIG, Ph.D.
Chief Economist
Global
taimurbaig@dbs.com

Wei Liang CHANG
FX & Credit Strategist
Global
weiliangchang@dbs.com

Tracy Li Jun LIM
Credit Analyst
USD Credit
tracylimt@dbs.com

Amanda SEAH
Credit Analyst
SGD Credit
amandaseah@dbs.com

Nathan CHOW
Senior Economist
China/HK SAR
nathanchow@dbs.com

Eugene LEOW
Senior Rates Strategist
G3 & Asia
eugeneleow@dbs.com

Daisy SHARMA
Analyst
Data Analytics
daisy@dbs.com

Han Teng CHUA, CFA
Economist
Asean
hantengchua@dbs.com

Teng Chong LIM
Credit Analyst
SGD Credit
tengchonglim@dbs.com

Joel SIEW, CFA
Credit Analyst
SGD Credit
joelsiew@dbs.com

Mo JI, Ph.D.
Chief Economist
China/HK SAR
mojim@dbs.com

Tieying MA, CFA
Senior Economist
Japan, South Korea, Taiwan
matieying@dbs.com

Mervyn TEO
Credit Strategist
USD Credit
mervynteo@dbs.com

Byron LAM
Economist
China/HK SAR
byronlamfc@dbs.com

Radhika RAO
Senior Economist
Eurozone, India, Indonesia
radhikarao@dbs.com

Samuel TSE
Economist/Strategist
China/HK SAR
samueltse@dbs.com

Violet LEE
Associate
Publications
violetleeyh@dbs.com

Philip WEE
Senior FX Strategist
Global
philipwee@dbs.com

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DBS Bank Ltd., 12 Marina Boulevard, Marina Bay Financial Centre Tower 3, Singapore 018982. Tel: 65-6878-8888. Company Registration No. 196800306E.

DBS Bank Ltd., Hong Kong Branch, a company incorporated in Singapore with limited liability. 18th Floor, The Center, 99 Queen's Road Central, Central, Hong Kong SAR.

DBS Bank (Hong Kong) Limited, a company incorporated in Hong Kong with limited liability. 13th Floor One Island East, 18 Westlands Road, Quarry Bay, Hong Kong SAR

AllianceDBS Research Sdn Bhd (128540 U), 19th Floor, Menara Multi-Purpose, Capital Square, 8 Jalan Munshi Abdullah, 50100 Kuala Lumpur, Malaysia. Tel.: +603 2604 3915.