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# AIP

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## **Fed holds, ECB cuts; eye on tariffs**

The Fed, after holding its key rate at 4.5% as expected, indicated future policy moves depend on the impact of Trump's policies. The ECB cut its key rate by 25bps to 2.75% as expected and signaled more cuts ahead amid slowing growth and trade uncertainty. US stocks initially fell, and the USD and government bond yields rose after a hawkish Fed statement, although they reversed course after Chair Powell said rates remained restrictive, leaving the door open for further cuts. Euro area stocks rose, and bond yields and the EUR fell after the ECB signaled further rate cuts ahead. Watching tariffs; looking to sell USD, buy bonds: After the widely anticipated central bank policy moves, focus turns to whether Trump will follow through with his threat to impose tariffs by 1 February. We will look to sell the USD and buy bonds to lock in attractive yields if a blanket tariff temporarily lifts the USD and bond yields. Bullish on US technology sector equities: Some US "Magnificent 7" members missed Q4 earnings estimates, but robust guidance on AI-related demand supports positive view on the US technology and communication sectors. The emergence of China's low-cost AI model Deep Seek, which caused market volatility earlier this week, is likely to boost AI use, benefitting software and services providers.

## **Background and policy implications**

Causation Fed. Chair Powell reminded markets that the Fed was in "no hurry" to cut rates as they remain restrictive despite 100bps of cuts since last September. Nevertheless, his comments also imply the Fed has scope to cut rates further, but uncertainty around Trump's policies is holding it back. The inflation and job market impact of Trump's tariffs, tax and spending cuts, migrant deportations and deregulation efforts will likely determine how soon the Fed cuts next. Rate cut expectations pushed back. Money markets have lowered the chances of a March rate cut to 17% from 30% before this week's meeting. However, there are two sets of US inflation and job market data scheduled before the next Fed meeting on 19 March. Two straight months of 0.2% m/m or weaker core inflation and payrolls significantly below 100,000 are likely needed to revive rate cut bets. Tariffs to lift near-term inflation, hurt medium-term growth: While the market awaits details of Trump's tariff plans, history shows Trump's prior tariffs imposed in 2018 lifted short-term inflation, but hit medium-term growth. This explains why bond yields initially rose after tariffs were imposed in 2018 but then fell sharply after a few months on concerns about growth. We will thus take advantage of any tariff-driven rise in bond yields to lock in yields for the long term.

## Equities

The key near-term driver of equities is likely the news flow surrounding Deep Seek, which led to a rout in AI-related sectors such as semiconductor and related equipment earlier this week. In our view, Deep Seek showed that low-cost AI alternatives are possible, and this will lead companies to focus on efficiency of AI-investments. It would also lead to the higher-cost producers to concentrate on development of “higher-value” areas of AI, such as agentic and physical AI. All in all, we believe this is likely to increase the “size of the pie” in the AI industry, which ultimately is positive for the long-term. This supports our stance to buy US equities on dips, especially in the broader US technology and communication services sectors. However, in the near-term, there is likely to be volatility ahead in specific industries or stocks, especially with Trump’s tariff threats. Thus, investors should consider averaging into areas, such as semiconductors. The next key support for the S&P500 index is around 5,800, followed by 5,600. Meanwhile, investors should maintain a diversified portfolio, with a core equity allocation to Asia ex-Japan equities, especially if AI innovation in China revives productivity and investor sentiment.

## Bonds

Fed Chair Powell’s remark that “we do not need to be in a hurry to adjust our policy stance” did not trigger a surge in bond yields, with the US 10-year government bond yield staying around 4.5%. The yield has declined from a 14-month high of 4.8% in early January. We expect any tariff-related bounce in the yield to be capped around 5% by concerns about medium-term growth. We anticipate three Fed rate cuts in 2025, compared with two cuts priced by money markets. As a result, there is an opportunity to lock in the currently attractive yields. Technical indicators show the 10-year yield is testing strong support at the 50-day moving average of 4.48%. A break lower could lead to a test of the next support at 4.25%, while next resistance is at 4.63% with China’s high dividend paying non-financial state-owned company.

## FX

The USD index (DXY) has fallen almost 2% from a two-year high just above 110 in early January amid easing concerns about tariffs. While the dollar could bounce if Trump imposes a blanket tariff in the near term, we see the DXY capped around 109-110 amid concerns about a possible softening of the US job market in the coming months. President Trump’s orders to reduce the size of federal government employment will likely lift the number of unemployed, even as his deportation of illegal migrants' cuts labor supply (undocumented migrants accounted for almost two-thirds of job growth last year). However, DXY downside is likely to be limited by a dovish ECB. ECB President Lagarde, after cutting the key deposit rate for the fifth straight meeting, said that rates remained restrictive, and that the disinflation process was on track. As a result, money markets are now pricing in three more 25bps rate cuts this year. On technical charts, EUR/USD’s bullish momentum shows signs of fading, raising the chance of a pullback in the coming week. A break below the first support at 1.0340 could pave the way for a test of 1.0180.

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