Weekly Market Summary

27th of May 2016

All Eyes on Janet Yellen This Afternoon…All Ears on China's Earlier Preference for Delayed US Rate Hikes!?! Fadi Nasser (SVP – Head of Treasury Sales)

Markets -in general - have been remarkably calm in past week, and as a result realized volatility has dropped sharply across asset classes. Whilst such development is usually positive and constructive for financial markets/instruments, the timing seems striking to us given the recent major re-pricing of Fed risks, the continuing rise in oil prices and ongoing uncertainties over the health of China/Japan's economies as well as the upcoming Brexit vote. Against this backdrop, G-7 equity markets have inched higher in past days while bond yields have partly reversed the upward momentum witnessed the week before (but again, why would bonds rally in a "risk-on" mood/environment. I am honestly totally clueless on that, unless someone tries again "convincing" me that investors are still reaching for yields?!)

Fed officials continue to make a strong case for an impending rate hike: From John Williams to Esther George, Eric Rosengren, Jeffrey Lacker, Bill Dudley, Patrick Harker and James Bullard - the list of FOMC members who have recently sounded surprisingly hawkish (i.e. upbeat on growth and inflation prospects, and hence more inclined to vote in favor of raising rates) just keeps growing! As recently as early May, a Fed rate hike in June was completely off the agenda. After all, the statement that accompanied the April 27th FOMC made no mention of an imminent rate hike, suggesting that the doves within the FOMC had the upper hand. Moreover, since first-quarter US GDP was quite disappointing (initial release came out as +0.5% QoQ annualized, but such is expected to be revised upwards to +0.9% later this afternoon), market expectations had quickly shifted towards a rate hike later this year or early in 2017.

This market interpretation proved to be wrong, and minutes of the April meeting – published a week back – confirmed that most Fed officials viewed poor 1st quarter economic performance as a one-off, and felt that a June rate rise was still on the agenda subject to the right mix of US economic data and global financial conditions. This morning, the likelihood of a rate move - based on the Fed Funds Futures - stood at roughly 33%. Mind you, such reading remains quite depressed after the latest stretch of Fed hawkish talk, and clearly points at an apparent loss of credibility on the part of the Fed! Put simply, anyone who is too hesitant ("cry wolf") will not attract the required attention at some stage, and US Fed governors appear to have fallen into such trap.

So will the Fed really act as early as June 15th, or is this yet another false alarm? Did Fed officials simply no longer want to accept that the market is refusing to be convinced that the Fed may take action again and that US long yields will stay absurdly depressed? Of course it is a major problem for central bankers if their comments no longer attract attention on the market, as it simply makes it impossible to fine-tune market expectations under these circumstances. In this context, does this recent turnaround also mean all those comments made over the past two weeks were the outcome of a carefully planned strategy?

A kind of repair program for the Fed's credibility? Anything else would no doubt completely ruin the Fed's credibility on the market for the foreseeable future! But if that is truly the case, wouldn't it be more sensible for market players to start taking the Fed more seriously and early prepare for higher interest rates in the short term!!

Which brings me to the final question for the day: What will Janet Yellen comment on the matter this afternoon when she engages in "*a conversation about her groundbreaking achievements*" at an event in Massachusetts (starts at 20:15 Bahrain time)? One presumes Yellen would assume her responsibilities as Fed Chair and go down the same route as her Fed lieutenants. In that case, expectations of an imminent rate rise would become a majority view rather than a minority one, the USD would continue to appreciate, gold would be sold and bond yields would rally sharply! Otherwise, should Yellen choose to focus on her "groundbreaking achievements" (a conversation that shouldn't last more than 60 seconds if you ask me!) and not mention rate hikes, the market might consider this as another dampener. As a reminder, bond markets will have an early close this evening, ahead of the long Memorial Day weekend and Fed Chair Yellen could easily avoid saying anything too earth-shaking, opting instead to keep market volatility low.

Last, markets learned on Wednesday that Chinese officials were planning to press their American counterparts in annual talks next month (the annual U.S.-China Strategic and Economic dialog talks are scheduled for June 6-7th in Beijing) on the chance of a Federal Reserve interest-rate increase in June. The nation's policy makers apparently want to better prepare for the potential impact on financial markets and the yuan (Seriously?! All this panic for a long telegraphed 25 bps rate hike?!). In China's view, if the Fed does lift borrowing costs, then a July move would be preferable – according to people familiar with the matter! Gladly, China's central bank denied the story on Wednesday evening and again yesterday, with a press officer for the People's Bank of China (you would surely agree with me that this chap qualifies for a "superior" familiar person on the same matter!) confirming the whole story is a lie.

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