Weekly Market Summary

16th of September 2016

Lael Brainard Says NO to a US Rate Hike on September 21st.... Who on Earth is Lael Brainard??

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The tranquility that has enveloped global markets for more than two months was upended over the past few days, as central bankers in Europe and Japan begin questioning the benefits of further monetary easing, whilst many Federal Reserve officials warn that waiting too long to raise US interest rates threatens to overheat the US economy. Such hawkish change in tone was sufficient to send most asset classes – including government debt, stocks and emerging-market assets – to their biggest declines since June. The S&P 500 Index, emerging-market assets and global equities fell the most since Britain voted to secede from the European Union, as the yield on the 10-year Treasury note was jumping to its highest since June (1.75% at one point yesterday). German 10-year yields rose to positive territory this week, for the first time since July, after the European Central Bank downplayed the need for more stimulus at its meeting last Thursday.

The generalized move down in stocks has sparked an interesting discussion about how investors should respond. After all, markets have experienced such sudden air pockets in the past year, though similar events have been rather infrequent given the context of unusually low market volatility, and all have proved both temporary and quickly reversible. Whether this equity market selloff will follow the same course is, of course, open to debate. Already, some are urging investors to "*buy the dip*," hoping to repeat a strategy that has proved extremely profitable since the start of 2016. Other market experts are more cautious, and some have suggested that investors should sell before prices fall even further. Honestly, where one end up on this issue has less to do with his/her assessment of corporate and economic fundamentals than with how he/she see the prospects for a continuation of the recent exceptional period of both public and private liquidity support for financial markets. After all, the International Monetary Fund (IMF) Managing Director Christine Lagarde recently signaled that her team was again likely to revise downward its forecasts for global growth, a confirmation that the world economy remains fragile and uneven.

And surely politics and geopolitics are not helping too! The political context in many Western countries is far from conducive to calm and sound economic policy: The U.S. is in the final stretch of a contentious presidential election, where Republican presidential nominee Donald Trump is now leading Hillary Clinton in many polls; in the U.K., the consequences of the BREXIT vote in June have yet to become clear in terms of policy and institutional changes; Italy is facing its own defining referendum; Spain is struggling to form a government, and in Germany, the governing party of Chancellor Angela Merkel has lately suffered a humiliating local election defeat to the anti-establishment AFD party. Geopolitics also add uncertainty, including a defiant North Korea, continuing turmoil in the Middle East, as well as the threat from non-state actors, terror groups, which amplify a sense of new unpredictability.

However those economic, political and geopolitical factors are not new. Indeed, until now, the winning trade has been to shrug them off, with markets convinced that the occasional selloff will be both temporary and reversible. Needless to re-emphasize that the main reason is not that stock valuations have been ultra-cheap (they have not!).

It is that downward trends have been more than offset by liquidity injections, particularly those from share repurchases by corporations, including those with large amounts of cash on their balance sheets, and unconventional central bank policies that have involved sizable asset-purchase programs. Those liquidity injections - and the incremental market demand that comes with them - have in turn delivered to investors a boost in asset prices and a repression of volatility, encouraging many to take on more market exposure for each unit of allowable risk.

Late last week however, it appeared as if the dominating impact of excess liquidity will soon change and potentially wane. This was particularly the case for more "reluctant" central banks, whose market intervention seemed to be evolving because of a change in what former Fed Chairman Ben Bernanke described as a "benefit, cost and risk" equation. The shift is not just a matter of the declining benefits of prolonged unconventional monetary measures - characterized by less central bank policy economic effectiveness overall (and most likely counterproductive) – but also the result of (justified) mounting concerns about collateral damage and unintended consequences, especially when it comes to the detrimental effects of ultra-low and negative nominal interest rates, distortions to the healthy functioning of markets, mounting threats of future financial instability and central bank vulnerability to political interference.

And then Lael Brainard spoke ……..

On Friday, September 9th evening, markets learned about a late arrangement for a speech to be delivered by the most dovish Fed board member – Lael Brainard – on Monday afternoon, just hours before the Fed black-out period begins (usually starts the Tuesday of the week preceding a Federal Open market Committee "FOMC" meeting). Traders quite rightly concluded that there was only one person that could effectively prepare the market for a September rate hike - Lael Brainard – as her views had traditionally been biased to allowing a sustained pickup in growth and inflation before concluding that rates would need to rise. For Fed followers, the linguistic embellishments that were used to describe this upcoming speech were melodramatic and surreal, to say the least. One was expected to believe that the global economy, the Fed's "remaining" credibility and trillions of dollars of hard-earned wealth effect hang in the balance. Truth is, Brainard has very little influence on markets (99% of Americans had never heard of her before! And the heavy weights at the Federal Reserve have always been Fed Chair Janet Yellen, Fed Vice-Chair Stanley Fischer and NY Fed President William Dudley) and her latest speech hardly deviated from previous notes. "*Continued prudence*" in raising U.S. interest rates is warranted, Lael Brainard said. Speaking before the Chicago Council on Global Affairs, Brainard added that inflation has been below the Fed's target for 51 months and "*the case to tighten policy pre-emptively is less compelling*" in an environment where falling unemployment has been slow to spur faster inflation.

This morning, updated probabilities for a potential 25 bps in the US Fed funds rate (last at 0.375%) at upcoming FOMC meetings are displayed below:

FOMC Meeting	21st September 2016	2nd November 2016	14th December 2016	1st February 2017
Probability of 25 bps hike	10%	20%	45%	50%

Following the release of weaker-than-expected US economic data in past days (ISM manufacturing & Non-Manufacturing, Retail Sales, Industrial Production, Business Inventories), coupled with lower oil and equity valuations, we are now more inclined to go for a US Federal Reserve on hold when it meets next Wednesday, 21st September, whilst noting that one or two Fed policymakers will potentially dissent in favor of a 25 basis point hike.

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