Weekly Market Summary

18th of March 2016

The US Federal Reserve Forward Misguidance & Irrelevant Dot Plots!!
Fadi Nasser (SVP – Head of Treasury Sales)

Back in the spring of 2009, two-year US treasury yields remained - for months - confined in a very narrow range (0.85% -- 1.05%). Then a stronger US job growth release took markets completely by surprise and lead to large intraday moves: May payrolls – released on June 5th, 2009 - fell by 345,000 (yes a drop, - 345,000, negative print!) – the least in eight months - after a revised 504,000 loss the previous month. And whilst the jobless rate increased to 9.4%, the highest since 1983, the better-than-anticipated number reinforced signs that the deepest recession in half a century was starting to abate. The dollar rallied and Treasuries fell as optimism grew that the economy's slump will soon end: Yields on benchmark 2-year U.S. notes jumped 30 bps to 1.40%, whilst the dollar climbed to a three-week high against the yen and 2-month high against the euro, to 98.22 and 1.38 respectively. The Standard & Poor's 500 Stock Index rallied 0.5% to 950! U.S. GDP growth – released a month earlier – had shown a 5.4% annualized contraction (yes a drop, -5.4%, negative print!) in the first quarter of 2009, a marked improvement from the 4Q2008 reading of -8.2%!!

Fast forward to March 16th 2016…… Forward Misguidance & Irrelevant Dot Plots

With the world's largest economy adding 8.5 million jobs since early 2013 (if the number looks too big to swallow, here is the precise breakdown: 2.311 million in 2013, 3.015 million in 2014, 2.744 million in 2015 and a total of 414,000 in the first 2 months of 2016), growth settling in a 2.00% -2.50% range (positive print!) during that same period, the unemployment rate last hovering at an 8-year low of 4.9%, core CPI and wage pressure starting to build up (I am referring here to Former Federal Reserve Chairman Alan Greenspan's interviews with Bloomberg TV yesterday, where he suggested that inflation is re-emerging as an issue for the economy and that there should be greater concern about it. When asked if concern about inflation should be deepening, Greenspan responded, "very much so."!), and US stocks trading near record highs (S&P 500 last at 2,041, versus a low of 676 registered in March 2009!) …… So with such impressive & improving US economic backdrop:

Federal Reserve officials held off from raising borrowing costs (as expected) at their March 16th meeting, keeping the target range for the benchmark Federal funds rate at 0.25% to 0.5%. The Federal Open Market Committee (FOMC) scaled back forecasts for how high interest rates will rise this year and next (more than expected), citing the potential impact from weaker global growth and financial-market turmoil on the U.S. economy. "*Economic activity has been expanding at a moderate pace*," with household spending gaining amid "*soft*" company investment and net exports, the Fed said. While inflation has "*picked up in recent months*," market-based measures of inflation compensation are still low, the central bank added.

The median of policy makers' updated quarterly projections – known as the "dot plot" saw the rate at 0.875% at the end of 2016, implying two quarter-point increases this year, down from four forecast in December.
It also saw the Federal funds rate at 1.875% at the end of 2017, compared with 2.375% forecast in December. The end-2018 level fell to 3%, from 3.25%, with the longer-run projection at 3.25%, down from 3.5%. Additionally, policy makers maintained their projections on how soon inflation will return to the Fed's 2% target, while cutting their inflation forecast to 1.2% this year from 1.6%. Officials still see the preferred price gauge rising 1.9% in 2017 and 2% in 2018. Officials also maintained their forecast for a 4.7% U.S. unemployment rate in the fourth quarter of this year, whilst the median projection for 2017 and 2018 fell to 4.6% (from 4.7%) and 4.5% (from 4.7%) respectively.

"*You have seen a shift this time, in most participants' assessments of the appropriate path for policy*," Fed Chair Janet Yellen said at a press conference that followed the rate decision. "*That largely reflects a somewhat slower projected path for global growth, for growth in the global economy outside the United States, and for some tightening in credit conditions in the form of an increase in spreads*. *The committee currently expects that, with gradual adjustments in the stance of monetary policy, economic activity will expand at a moderate pace and labor market indicators will continue to strengthen*," the FOMC said in its statement. "*However, global economic and financial developments continue to pose risks*." Kansas City Fed President Esther George dissented from the decision, preferring a quarter-point rate increase.

With the tone of the FOMC statement and accompanying economic projections being largely on the dovish side, both yields on Treasury securities and the USD fell, while stocks rallied. The rate on the 2-year Treasury note dropped 11 bps to 0.85% (from 0.96% prior to the announcement). The US dollar fell against all of its 16 major peers and was last trading at 1.1290 and 111.30 versus the Euro and the Japanese Yen (it was sitting at 1.1080 and 113.75 respectively prior to the Fed announcement). The S&P 500 rallied 1.25% in the past 2 sessions, closing at 2041 yesterday.

"*If the current conditions were not sufficient for the Fed to raise rates, what would those conditions ever look like?*" This was the question posed by a journalist and addressed at Fed chair Janet Yellen at Thursday's FOMC press conference. Surely that question is logical and justified (mind you that same journalist could have simply asked whether the Fed had any credibility left?!)

Market uncertainties and the increased volatility that has dominated the market in January and early February are over, the US labor market is developing very well, inflation rates are approaching the Fed target (core CPI inflation in February even reached +2.3% YoY!). The FOMC nonetheless remains skeptical, and their newly released dovish "dots" suggest that the downward revision of the future trajectory for the US Fed funds rate since 2014 continues unabated. After all, they could always refer to external developments to justify their cautious stance: Growth is slowing in China … fourth quarter GDP was negative in Japan … Europe continues growing at an anemic rate … and Emerging markets have been weighed down by declines in oil prices and increasing capital outflows.

Still, the above justifications did not prevent Mrs. Yellen from stating that "*April remains a live meeting*", when asked about the timing of the next rate move. "*There will be additional data on the labor market, and on various factors that pertain to inflation. So that is certainly a live possibility*" (confusing to say the least!?)

With the Fed's latest surprisingly dovish message, the European Central Bank's unleash of another round of unprecedented stimulus that included a cut in a key interest rate further below zero, the Bank of Japan holding fire on further stimulus, but laying the groundwork for additional easing after cutting its deposit rate to - 0.1% in January (this morning, 10-year Japanese bond yields traded down to a record low of -13 bps or -0.13%!) and China's central bank cutting the main interest rate to a record low in six successive reductions through October (and recently making another reduction to the required-reserve ratio for major banks), one has to ponder what comes next ?! After all, forward guidance was supposed to give businesses and consumers a reliable feel for where borrowing costs are headed. Increasingly, though, central bankers, in financial markets' jargon, are becoming price takers rather than price makers!!

Disclaimer

It is important that you only use this report if you are the intended recipient of this report and you have satisfied yourself that you are eligible to receive such information. This report is provided to you because you are one of our esteemed customers and have previously shown interest in receiving the type of information contained in this report.

The Treasury and Investment Management department of Gulf International Bank B.S.C. ("GIB") have compiled the information in this report. GIB is incorporated in the Kingdom of Bahrain and is licensed by the Central Bank of Bahrain (the "CBB") as a conventional wholesale bank. GIB's head office is located at Al-Dowali Building, P.O. Box 1017, 3 Palace Avenue, Manama, Kingdom of Bahrain.

This report is intended for the accredited investors, as defined in the Investment Business Code of Conduct published by the CBB. This information has not been reviewed by the CBB or any other regulatory authority in any jurisdiction and neither CBB nor any other regulatory takes any responsibility for the correctness or accuracy for the information contained in this report.

The information contained herein is not directed at or intended for use by any person resident or located in any jurisdiction where (1) the distribution of such information is contrary to the laws of such jurisdiction or (2) such distribution is prohibited without obtaining the necessary licenses or authorizations by the relevant branch, subsidiary or affiliate office of GIB and such licenses or authorizations have not been obtained. The recipient of such information is responsible for ensuring that this information has not been received by it in breach of laws and regulations of any jurisdiction.

This report contains publicly available information only, which has only been complied by GIB. The information provided herein is on "as is" and "as available" basis and without representation or warranty of any kind. GIB hereby disclaims any representation or warranty, express or implied, as to the accuracy, timeliness, completeness, merchantability, fitness for any particular purpose or non-infringement of any of such information. In no event shall GIB or its subsidiaries, affiliates, shareholders or their directors, officers, employees, independent contractors, agents and representatives (collectively, "GIB Representatives") be liable (1) for any inaccuracy, delay, loss of data, interruption in service, error or omission or for any damages resulting there from, or (2) for any direct, indirect, incidental, special, compensatory or consequential damages arising from any use of information or arising from any error (negligent or otherwise) or other circumstance or contingency within or outside the control of GIB or any GIB Representative, in connection with or related to obtaining, collecting, compiling, analyzing, interpreting, communicating, publishing or delivering any such information. The information here is, and must be construed solely as, compilation of information (unless expressly stated otherwise) and not statements of fact as to credit worthiness or recommendations or opinions of GIB.

This report does not provide individually tailored investment advice. Any materials contained herein have no regard to the specific investment objectives, financial situation or particular needs of any specific recipient. The document is provided for information purposes and is not to be construed as a solicitation or an offer to buy or sell any securities or related financial instruments. GIB makes every effort to use reliable, comprehensive information, but we do not represent that it is accurate or complete. No representation or warranty, either express or implied, is provided in relation to the accuracy, completeness or reliability of the materials, nor are they a complete statement of the securities, markets or developments referred to herein. Recipients should not regard the materials as a substitute for the exercise of their own judgement. Any opinions are subject to change without notice and may differ or be contrary to opinions expressed by other business areas or groups of GIB as a result of using different assumptions and criteria. GIB is not under any obligation to update or keep current the information contained herein.

The value of, and income from, your investments may vary because of changes in interest rates or foreign exchange rates, securities prices or market indexes, operational or financial conditions of companies or other factors. Past performance is not necessarily a guide to future performance. Estimates of future performance are based on assumptions that may not be realised.

The information contained in this report is just for informational purposes. Information does not constitute a solicitation, an offer, or a recommendation to buy or sell any investment instruments, to effect any transactions, or to conclude any legal act of any kind whatsoever. GIB does not intend to provide investment, legal or tax advice through this report and does not represent that any securities or services discussed are suitable for any investor. When making a decision about your investments and business, you should seek the advice of professional advisors.

The report may contain statements that constitute "forward looking statements". While these forward looking statements may represent GIB's judgment and future expectations, a number of risks, uncertainties and other important factors could cause actual developments and results to differ materially from GIB's expectations. GIB is under no obligation to (and expressly disclaims any such obligation to) update or alter its forward-looking statements whether as a result of new information, future events, or otherwise. The historical information is provided for information purposes only. Performance figures are calculated before tax (if any) and after deducting ongoing fees and expenses. The performance figures are historical and past performance is not necessarily an indication of future results. Certain amounts (including %ages) included in this document may have been subject to rounding adjustments. Accordingly, figures may not be an exact arithmetic aggregation of the figures to which they relate. The values and forecasts shown represent our current indicative valuations and forecasts of the relevant transactions, currencies, interest rates, commodities or securities as at the date shown. Any value or forecast shown herein is not an indicative price quotation. We expressly disclaim any responsibility for the accuracy of the values or forecasts shown, any errors or omissions in the report

With the exception of information regarding GIB and save as otherwise specifically indicated, the information set out in this report is based on public information. We have, where possible, indicated the primary source of information. We strongly recommend the recipients consult the primary source of information. Facts and views in this report have not been reviewed by, and may not reflect information known to, professionals in other GIB business areas.

This Report, and the information contained herein (save to the extent that such information is publicly available) is confidential and may not be disclosed by you to any other person outside of your organization without our consent.