Weekly Market Summary

18th of September 2015

Another Fed Meeting Comes and Goes! US Central Bankers Not In Any Rush to Raise Rates! - Fadi Nasser (SVP – Head of Treasury Sales)

In mid-May 2013, US Fed Chairman Ben Bernanke hinted that the central bank could begin to reduce the monthly pace of bond purchases (Quantitative Easing) in the next few meetings if it can be confident of sustained gains in the economy. "*If we see continued improvement, and we have confidence that is going to be sustained, we could in the next few meetings take a step down in our pace of purchases*", Bernanke said. Asked if tapering could be announced before Labor Day (September 2nd), Bernanke added that this was "***possible***" - something markets seem to have quite focused on given the sharp bond market selloff that followed that observation, though it was not all clear whether the Chairman's intention was to indicate that the Fed would be sending a signal on a QE taper over this period.

Nonetheless, it took the Federal Reserve a full six month (Fed refrained from taking action at the September 18th and October 30th) to eventually kickoff its bond tapering operation at the December 18th gathering (US$ 10 billion off monthly Treasury and MBS purchases). In addition - as a counterweight to try to stave off a very bearish equity and bond market reaction - the Fed said it expects to keep the funds rate at zero until "**well past**" the unemployment hits **6.5%**.

Fast forward to September 2015 …

Almost two years to the day in September 2013 when the Fed delayed tapering - and 2466 days and still counting since rates were last dropped to almost zero in December 2008 – (not to mention a 5.1% unemployment rate!) the Federal Open Market Committee ("FOMC") showed yet again stage fright about starting to end the easy money era, preferring to keep its benchmark Fed funds rate unchanged between 0%-0.25% . In addition to passing on the first rate hike in about nine years, the Fed lowered its rate projections across the curve by about 25bp (Fed Dot Plots reproduced below), citing global economic and financial developments that may restrain activity and lower inflation. Yesterday's decision and rate projections are the fourth in a string of dovish ones that began two years ago, and also include the March 2015 and June 2015 cuts in the dots.

Concerns regarding the international outlook and trend in market-based inflation expectations appear to have been the main two factors that stayed the hand of policymakers even in the face of an improving domestic economy. By still looking for "*some*" further improvement in labor market conditions and "*reasonable confidence*" that inflation will return to target over time, the chances of an October move appear low, meaning that December becomes now the most likely time for lift-off. In any case, whether the FOMC moves at the October 28th or December 16th meeting, it appears clearly that the upcoming rate hike cycle will be very gradual.

The FOMC members' projections for the Fed funds rate were only revised slightly lower from their June forecasts. Thirteen members still think that it will be appropriate for the first hike to come this year, only two lower than in June's prior projections. In addition, the lower projections for 2016 and 2017 simply reflects a later start than the earlier projections rather than a flatter trajectory. Nevertheless, in a dovish signal, the FOMC members' projection for the longer-run normal level of the funds rate was also lowered to 3.5%, from 3.75%. The median projection for headline and core PCE inflation were both also lowered a tick for 2016 and 2017 meaning that inflation is not expected to reach the FOMC's target until 2018. While, in addition, the forecast for the "long-term" unemployment rate was again lowered (median now stands at 4.9%), to reflect the fact that markets are not seeing any wage pressure even though
the jobless rate is down to 5.1%.

Chair Yellen's press conference was in line with the FOMC's statement with a fairly dovish tone; There too, market-based inflation expectations were highlighted as being of some concern to committee members. Yellen also specifically mentioned that the appropriate path of policy may have been delayed somewhat given that, altogether, the drop in equity prices, increase in credit spreads and strengthening dollar had effectively already tightened financial conditions. She went on to clarify that, despite the unemployment rate being very low, other measures of labor market slack (labor force participation, involuntary part-time employment) leave room for further improvement. Nevertheless, the Fed Chair implicitly suggested that she expected these headwinds to be transitory as she stated that they had not fundamentally altered the positive outlook for the economy.

US stock markets fluctuated throughout yesterday's session, closing mostly down on the day. This morning, Asian and European stocks followed suit, declining as investors were left worrying about the lack of guidance from the central bank and its concern about the global economy. The dollar also remained under pressure, with the euro up 0.3% at $1.1445, after rallying by a full big figure following the Fed announcement yesterday (from $ 1.1310 to 1.1410). The U.S. currency was also lower against the Japanese yen, trading last at 119.15 yen. The Fed decision to keep rates on hold - whilst having little impact in energy markets - triggered a sharp rally in gold prices (up $20 in past 24 hours to $ 1138 last) and bond prices (2-year US Treasuries were the most affected, with the corresponding yield dropping by 14 basis points and trading at 0.66% last).

Last, but not least, it is worth reminding our valuable readers about the US Federal Reserve's previous experiment from a decade ago, when the US central bank held its interest rate at 1% for most of 2003 and 2004 even though the quarterly growth rate for those two years averaged 3.8%. By keeping borrowing costs so low for so long, the Fed helped finance a buying spree that saw investors loading up on toxic assets ranging from debt backed by mortgage that house buyers could not afford to collateralized debt obligations that even the rating agencies could not assay. And now, with monetary policy conditions at their loosest since the Fed was founded in 1913, and a Federal Reserve still wary of igniting market volatility, one has to wonder if markets are yet again experiencing "*a very strong sense of déjà vu*".

Updated Fed Dot Plot (Forecasted Federal funds rate at year-end as reported in the FOMC Economic

	YE 2015	YE 2016	YE 2017	YE 2018	Long Run
Sep-15 Median	0.375%	1.375%	2.625%	3.375%	3.5%
Jun-15 Median	0.625%	1.625%	2.875%		3.75%
Mar-15 Median	0.625%	1.875%	3.125%		3.75%

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