Weekly Market Summary

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Just When Markets Thought a September Rate Hike in the US Was a Clear Outcome!

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In past weeks, various Fed policy makers - including Fed Chair Janet Yellen, Atlanta Fed President Denis Lockhart and St. Louis' James Bullard – have voiced confidence in the state of the recovery and stated that positive growth prospects were bright enough for the Fed to begin its normalization of US short-term interest rates in the near future (closest FOMC meeting is scheduled for September 17th).

And then Chinese authorities devalued the Yuan and commodity prices continued their dive!

In a major surprise to global investors, China's first major devaluation since 1994 (close to 3.0% for the whole week) immediately fueled concern that authorities are struggling to combat a slowdown in the world's second-largest economy and will be using the Yuan to achieve stronger exports and reflate the Chinese economy (that is in contrast to recent assurances by the PBOC that it will only intervene in the foreign-exchange market to ensure the stability of the Yuan, while authorities have little interest to devalue further and surely no intentions to start a currency war). Where the Yuan goes from here is surely expected to have an impact - not only on growth prospects for Asia's largest economy - but also the Federal Reserve's interest-rate policy and earnings at international companies. Further weakness could also make dollar-denominated debt more expensive for Chinese borrowers, exacerbate capital outflows and put pressure on export rivals (Japan, Korea and others) to devalue their currencies.

As to commodity markets, they have been taking a severe beating for some time now (to be more precise from late June 2013!). The aggregate Bloomberg Commodities Index has moved down more than 60% from its 2008 peak and 46% from the 2011 post-crisis high The rout can partly be attributed to expectations that U.S. interest rates would soon rise and the recent Chinese economic slowdown (more recently the Chinese stock market correction/crash and last the Yuan devaluation), which made investors question the health of the world's second-biggest economy. Some market strategists even fear that the recent price drop could be signaling the beginning of a long downward cycle. With Chinese development slowing in past years, metals prices have moved sharply lower. Oil, too, has been falling in sync. with metals. The U.S. shale boom, huge investments in production expansion, the increase in OPEC production and the rise of sustainable energy in Europe, as well as improved energy efficiency in developed economies all point toward lower prices. The black gold - last trading US$ 42 and US$ 49 - for US WTI and Brent respectively - is headed for the longest run of weekly declines since January amid signs the global glut that had driven prices to the lowest in six years will be prolonged. "*The market surplus will last through 2016*", the International Energy Agency (IEA) said Wednesday, while OPEC reported on the same day that output climbed last month to the highest level in more than three years

Still, many economists and market participants – including ourselves – stand by their earlier projections for a September Federal Reserve 25 bps interest rate increase, the first rate move in 7 years (though it would be the first rate increase in 9 years, with the last rate hike taking place at the June 29th 2006 FOMC meeting!) despite the surprise Chinese devaluation and drop in oil & metal prices, both of which have heightened uncertainty in international markets. That compares to a recent Bloomberg survey (taken between August 7-12), which found only 77% of participants believe the Fed will raise its main policy rate next month, 11% projecting a December rate move, while 8% felt an increase at the October meeting - which isn't followed by a press conference – was the most likely outcome.

After all, US data released in early August (for the month of July) has shown resilience despite a persisting negative news flow from Greece during that period. The labor market has shown continued progress, with U.S. firms adding 215,000 jobs in July - compared with the year-to-date monthly average of 211,000- and the unemployment rate dipping to a seven year low of 5.3%, even as wages and productivity lag and a slowdown in China dims the international outlook. In addition, retail sales data – released yesterday - gave another signal that the economy is strengthening; Sales at U.S. retailers rose 0.6% MoM in July on growing demand for everything from cars to clothing, advancing from June's upwardly revised numbers. Trade remains the primary risk to the U.S. outlook, with a stronger dollar and sluggish global demand standing as two key obstacles (surely China's decision on Tuesday to devalue the yuan may further increase those headwinds).

Whether or not the latest information from China and the commodity markets discourage the Fed from raising rates in September remains the million dollar open question!! One thing for sure: Fed officials remain more confident with their forecast for a near term liftoff in rates, whilst markets are less sanguine. Investors this morning continue pricing in close to a 50% chance that the Fed will raise rates in September, based on today's pricing of Federal funds futures contracts (the Chicago Mercantile Exchange "CME" displays prices/allows active daily dealing of future Fed fund rates as well as 3-month interest rate futures). That in turn would surely provide trading opportunities for interest rate and foreign exchange traders, whichever way the September 17th FOMC vote is (year-end forecasts for US Treasury 10-year yields range between 2.25% and 3.25%, whilst EUR/USD year-end forecasts vary from 0.99 to 1.17!).

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