Weekly Market Summary

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To Hike or Not To Hike --- That is the Question

Fadi Nasser (SVP – Head of Treasury Sales)

As central bankers prepare to meet next week for the all-important Federal Open Market Committee ("FOMC") meeting on Thursday September 17th (in fact it will be a 2-day meeting with the rate announcement only expected on Thursday evening, 9:00 pm Bahrain, followed by Fed Chairwoman Janet Yellen's news conference 30 minutes later) and as Fed watchers debate the likelihood of the Federal Reserve voting to raise rates for the first time in 9 years, opinions amongst the market elite with regards to the Fed's most critical policy decision remain quite divided …. and that just days before the final verdict is out!

Not only is there no consensus about whether the Fed will end its seven-year-old policy of zero interest rates, but views on the fallout from such a move are wildly disparate too.

Whilst many prominent economists believe the Fed has every justification to proceed immediately with a symbolic and small rate rise, and will therefore not hesitate to pull the trigger on rates as soon as next Thursday, several smart guys in the room still lean in the other direction and speculate there will not be a US rate rise anytime soon, but rather a return to quantitative easing!! Former U.S. Treasury Secretary Lawrence Summers and reputable hedge-fund manager Ray Dalio (founder of Bridgewater Associates) are firmly in that camp, with both recently predicting that the Federal Reserve might need to restart its bond-buying program to extinguish the threat of deflation. This week, Citigroup chief economist Willem Buiter went a step further, warning that the world risks toppling back into recession in the next two years if central banks do not accelerate their efforts to pump cash into the economy (the logic goes that even after the Fed expanded its balance sheet by more than US$ 3.5 trillion from the start of Quantitative Easing "QE" in 2009 to its end in October 2014, global disinflation still persists).

Traders in the cash and future rate markets continue to scale back their expectations for a Fed move at the September 16-17th policy meeting. As of this morning, prices in the interest rate futures and options market suggest there is a one third chance of an increase, down from 50% almost a month back. Whether such benign pricing proves to be a fatal error or a blessing for some of the big bond and money market traders (an outcome that will only be known in a week time) is not the focus of this week's economic update, as we restrict/dedicate our market coverage to showing some of the influential beliefs (on the Fed's next course of action) that made the headlines in past days/weeks:

- **Federal Reserve Vice Chairman Stanley Fischer:** Fischer told Finance Ministers and central bankers at the last G-20 meeting in Ankara that policy will remain very expansionary even after first rate hike. However, Fischer suggested that he did not know what the outcome of the next Fed policy meeting will be (who knows then?!?)
- **IMF head Christine Lagarde:** The Fed must be certain that the job market and inflation are strong enough to justify raising interest rates. "*The Fed has not raised interest rates in such a long time, that it should really do it for good, not give it a try and then have to come back*" (sounds like a nursery teacher addressing kindergarten students !?!)
- **Former US Treasury Secretary Lawrence Summers:** The Fed should refrain from raising rates in September. Financial markets have already done the work of tightening. Additionally, the data flow suggests a slowing in the U.S. and global economies and reduced inflationary pressures.
- **Goldman Sachs:** A Fed rate increase is less likely as US and global stocks drop, while wage and price inflation continue to fall short of consensus expectations. GS baseline expectation is that the message from the meeting, including the "leadership dots", will remain broadly consistent with a lift-off in December 2015, though Chair Yellen will need to make it clear in her press conference that financial conditions would have to improve for the Committee to actually hike this year.
- **JPMorgan:** As far as the Fed is concerned, while we think the outcome of the September FOMC meeting is a very close call, we still believe the odds are tilted in favour of them raising the target range by 25 bps coupled with fairly dovish dots (in reference to the so-called Fed dot plot, which indicates where individual Fed officials see Fed Funds in the future (year-end 2015, 2016 & 2017).
- **Citibank:** The US economy is healthy enough seven years after the financial crisis to withstand higher rates.
- **BNP:** Despite resiliency in the domestic economy, the Fed will likely be very cautious next week. We expect no action on rates, a dovish set of economic and interest rate projections, and for the Chair to use her press conference to keep expectations of a hike "later this year" alive.
- **Deutsche Bank:** The Fed is on hold until markets make clear that they are ready to handle a change in the Fed's posture. Most importantly the financial markets have to be discounting a reasonably high probability of an interest rate hike to prevent any unpleasant surprises (Seriously?! Is this how monetary policymakers have conditioned the financial markets over the years? Guess not many have learned lessons from the 2007/08 market debacle L).
- **Barclays:** Believe the Fed will not hike at the September FOMC meeting, given the recent tightening in financial conditions and greater uncertainty about the inflation outlook.
- **Commerzbank**: We reckon that the Fed will hesitate one more time, postponing the lift-off until December 16th
- **Bank of Tokyo Mitsubishi:** The US economy is on track for the Fed to start normalizing rates. "Rate hikes are soon coming. Bet on it!"
- **Hedge Fund Manager Ray Dalio** (Bridgewater Associates manages approximately US$ 150 billion in assets under amangement!): A US rate increase will prove an epic blunder in the face of a vulnerable global economy, and will prompt policy makers to abruptly reverse course and start printing money again.

As to Ray Dalio and Larry Summer's views, it remains a puzzle to me why more QE would be the answer to the economy's "failure" thus far to respond to previous QE programs!! But when some of the "smartest" people in finance continue arguing for yet more monetary stimulus, it takes some guts for us to continue strongly arguing in favor of a rate hike, and for the Fed to start pushing up borrowing costs!

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