
Weekly Market Summary

9th of October 2015

How Close was the Fed Call on Rates in September??

Fadi Nasser (SVP – Head of Treasury Sales)

Three weeks back - as markets were heading into the Fed's September 17th FOMC meeting - we listed the pros and cons for the first US Fed funds rate hike in almost a decade:

"Whether conditions for Fed normalization have now been met remains unclear: The chaos and tightening of financial conditions that followed the August rout on global equity markets would clearly argue against that. Still, US data has continued showing improvement in the labor and housing markets. And whilst inflation remains benign, recent comments by Federal Reserve Vice Chairman Stanley Fischer clearly indicate a preference to proceed with rate normalization at the earliest. "Waiting for overwhelming" evidence to act on monetary policy would be a mistake. "If you wait that long, you will be waiting too long," Fischer said. "There is always uncertainty and we just have to recognize it. We will have to make a decision in the face of considerable uncertainty."

A survey carried by the FT on the same day also showed a **"close call"** with regards to a September US rate rise: *Economists who spoke to the FT said they saw roughly 50:50 odds on what the Fed will do this week — a proverbial "toss-up".*

We all know now what happened next: 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"). 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 appeared low, meaning that December had now become the most likely time for lift-off. In any case, whether the FOMC moves at the October 28th or December 16th meeting, it was clear that the upcoming rate hike cycle will be very gradual.

Hold On... Wait a second!!

John Williams, a centrist and president of the San Francisco Fed, confirmed - in the days following the Fed meeting - that the arguments for and against beginning to tighten U.S. monetary policy are about balanced now that the economy is on solid footing, giving him confidence in continued economic and labor market growth.

The Fed's decision to leave rates near zero "was a **close call** in my mind, in part reflecting the conflicting signals we are getting," he said. "The U.S. economy continues to strengthen while global developments pose downside risks to fully achieving our goals."

Those remarks were later echoed by another top Fed policymaker: An interest rate hike will likely be appropriate this year given the U.S. Federal Reserve's decision last week to stand pat was a "**close call**," Federal Reserve Bank of Atlanta President Dennis Lockhart said. Whilst recent market volatility raised risks to the U.S. economic and inflation outlook, Lockhart remains confident the central bank will raise interest rates this year. Lockhart added that he had voted with the majority as "prudent risk management around recent and current market volatility."

The decision not to act was also countered by two other policy makers who believe the economy has improved enough for the central bank to begin moving toward a more historically normal policy stance now. In a statement released few days after the Fed's meeting - explaining why he cast the sole to vote in favor of a rate rise - Richmond Fed President Jeffrey Lacker said "**it's time to recognize the substantial progress that has been achieved and align rates accordingly.**" Mr. Lacker said there would be no real cost with raising rates in this economy, and he dismissed fears that inflation is too low despite the fact the Fed has missed hitting its 2% target for three years and doesn't expect to get there until 2018. "Even after a quarter-point increase, interest rates would remain exceptionally low, providing ample support for economic growth," the official said. Speaking in Nashville on the same day, St. Louis Fed leader James Bullard said that if he had a vote on the FOMC now, Mr. Lacker's opposition would have been less lonely. "The case for policy normalization is quite strong" because the Fed has gotten what it set out to achieve with its hiring and inflation goals.

More Confusion Ahead!!

The above mix-up possibly explains why market participants (including us) closely awaited yesterday's release of the FOMC minutes from the Fed's September 16-17th policy setting meeting, with analysts looking for signals about just how near Fed officials were to raising interest rates in September and the arguments that ultimately persuaded them to leave rates unchanged near zero. The officials' "close call" comments relative to the market's earlier dovish interpretation of the Fed statement and press conference were expected to present those minutes as somewhat hawkish, in turn leading to a re-pricing of the US yield curve (currently hardly assuming any major hikes in the upcoming 5 years!) and resulting in a decent jump in short and medium-term yields.

Nonetheless, Fed Minutes released yesterday evening contained no real indication that the September meeting was **anywhere close to a "close call"**, despite all the public statements from Fed officials after the meeting to this effect. At best, they did show that Fed officials were feeling good about the U.S. economy (unemployment had fallen faster than they anticipated, consumer spending was picking up and the housing market was showing encouraging signs, headwinds keeping inflation below the Fed's 2% goal, like lower oil prices and a strong dollar, were judged to be transitory).

Yet the solid reading on the domestic economy was darkened by threats from abroad. China's slowing growth - which could spill over to other emerging market economies - raised risks the dollar might strengthen further, making U.S. exports more expensive in foreign markets and creating an additional drag on the economy. "*The committee decided that it was prudent to wait for additional information confirming that the economic outlook had not deteriorated,*" the minutes added, even as they noted that most Fed officials believed conditions would merit a hike later this year.

Some economists and market participants had already stopped believing the Fed will pull the trigger this year on the first rate increase. For them, the minutes bolstered that view. *“The Fed’s credibility is already in tatters,”* Stephen Stanley, chief economist at Amherst Pierpont Securities LLC in Stamford, Connecticut, wrote in a note to clients. *“Market participants have concluded that the Fed is going to find an excuse to extend super-accommodative policy for a very long time.”*

Michael Feroli, chief U.S. economist at JPMorgan Chase & Co. in New York - while still calling for a December move - also did not find much reassurance in the minutes for that assessment. *“Relative to our December call, the tone of these minutes increases the risk of a later liftoff,”* he wrote in a note to clients. Feroli also focused on language in the minutes suggesting that voting members of the committee were somewhat less inclined to hike than the full FOMC, where 13 of 17* members in September forecast a rate hike by year end, according to projections that they prepared for the meeting. *“Among those voters, ‘many’ expected the conditions for liftoff to be met later this year,”* Feroli wrote. “Many, but not most.”

**All members of the Fed’s Board of Governors in Washington -- of whom there are currently five -- have permanent votes on the FOMC, as well as the head of the New York Fed. Four other regional Fed presidents vote on an annually rotating basis.*

What Happens Next??

With the World Bank trimming its growth forecast for developing East Asian countries earlier this week - to reflect risks from China’s slowdown and a looming US interest rate hike (please do not refer any longer to that one as a close call !) - and the International Monetary Fund’s latest warning about elevated vulnerabilities in emerging market economies, lower risk appetite and higher market liquidity risks globally, one has to wonder if the US Federal Reserve will ever have the guts to raise US short rates anytime soon (call it Prudence over Pride, or better “We’re Totally Clueless versus we Thought We Understood Markets”).

One thing is for sure: Current communication by the Fed is doing more harm than good! Yellen's flip-flop probably means a wave of Wall Street revisions to their Fed fund rate forecasts today, next week and next month! Citigroup Inc. economist William Lee, for example, recently shifted his US rate lift-off call to spring 2016. In June, he had placed his bet on September, after previously anticipating a December move!

To be fair, the current economic backdrop to monetary policymaking is even more opaque than usual with uncertainties over China mounting, emerging markets looking vulnerable, the outlook for faster inflation non-existent (though very much at the mercy of weekly fluctuations in oil prices) at the same time as the U.S. labor market appears to be in rude health. Nevertheless, the forward guidance policy adopted in recent years by many central banks is in tatters, and has surely proven ineffective in telling companies and consumers when - and how fast - borrowing costs are likely to rise in the future.

That possibly explains the latest call from the IMF - in its Global Financial Stability Report – urging the US central bank to provide "clear and consistent" communication about the direction of monetary policy to allow "the smooth absorption of rising US rates, which is essential for global financial health."

One can only hope the Fed will listen to the IMF & market concerns the next time it meets!

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 compiled 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.

GIB retains all right, title and interest (including copyrights, trademarks, patents, as well as any other intellectual property or other right) in all information and content (including all text, data, graphics and logos) in this document. All recipients must not, without limitation, modify, copy, transmit, distribute, display, perform, reproduce, publish, license, frame, create derivative works from, transfer or otherwise use in any other way for commercial or public purposes in whole or in part any information, text, graphics, images from this document (excluding publicly available information) without the prior written permission of GIB.