Weekly Market Summary

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Did Fed Officials Just Announce an End to The Rally in US Asset Prices ?! Better Check with Jeffrey Lacker !

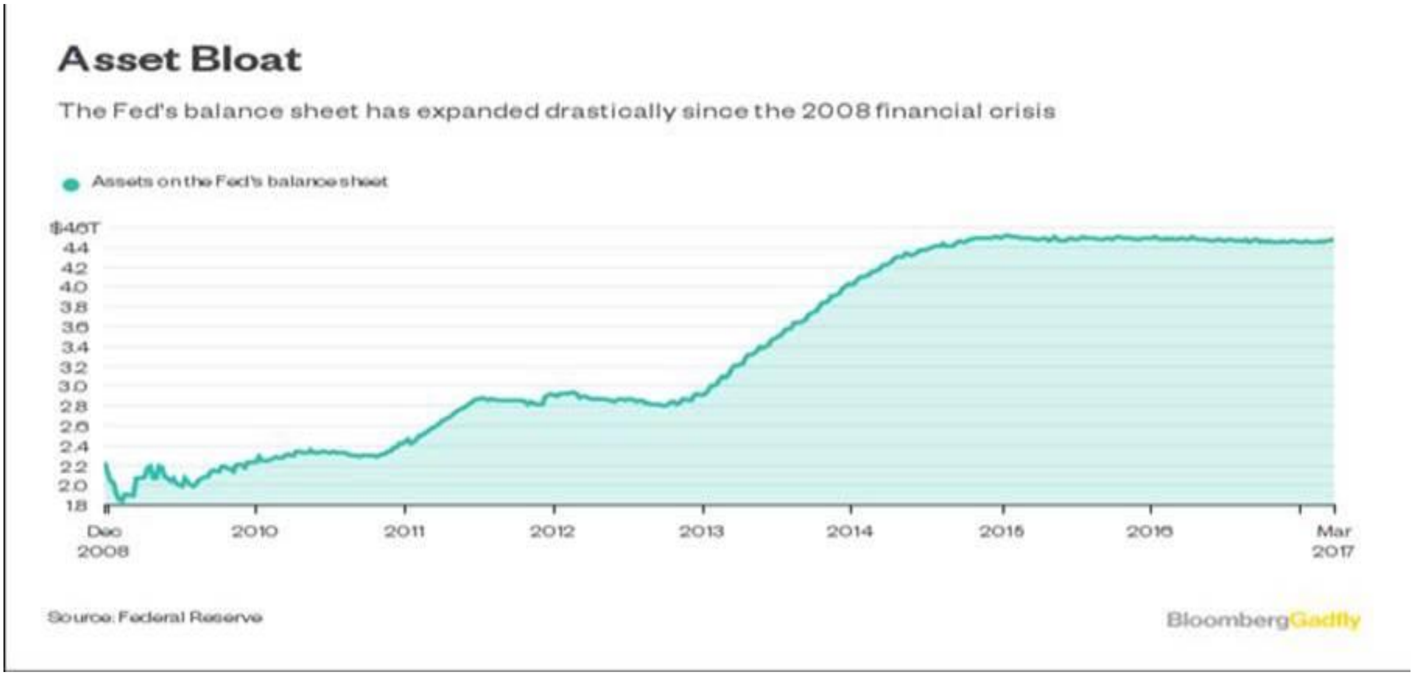
Fadi Nasser - Head of Treasury Sales

The Federal Reserve is trying to send a clear message to bond and equity traders: Prepare for a reduction in the Fed's US$ 4.5 trillion balance sheet and pay closer attention to current expensive stock valuations. But market traders aren't buying that yet!

A move by Fed officials to begin shrinking the central bank's balance sheet later this year – as suggested by the March FOMC minutes, released last Wednesday - would most likely cause longer-term borrowing costs to rise because the Fed has been a large buyer of Treasuries and mortgage debt since the 2008 financial crisis. More than US$ 400 billion of its holdings is set to mature next year, so a reduction in the Fed's reinvestment could potentially depress market values in a big way throughout 2018 (possibly leading to a jump in yields in excess of 50 bps). Still, debt investors are not anticipating (or more likely "are in denial!") that the Fed will take action soon, or at worst they remain complacent about how easy and smooth it will be for the Fed to unwind its historically inflated books: Over past weeks, even as a string of Fed members showed increasing support for shrinking the balance sheet, bond traders refrained from pricing-in any material shift in central bank strategy over the near future (in fact 10-year bond yields dropped 3 bps on Wednesday evening following the Fed minutes announcement, and were lower again this morning following the US missile strike on Syrian targets. 10s UST last trading at 2.32%!).

To be fair and clear, traders have been disregarding Fed projections and promises for years, and they have been right! Since late 2013, bond investors have made a lot of money by pricing in more subdued inflation and growth forecasts than central bankers, and assuming that Fed policy outcomes would ultimately be more accommodative than mainstream FOMC rhetoric implied at the time. Hence the current comfort level seen in the bond market, with recent steady low yields and suppressed volatility. Also for now, central bankers seems to be unwilling to push intermediate and long-term rates up prematurely – with pending uncertainties over Trump's fiscal policies, painful Brexit talks and French presidential elections just around the corner.

How much longer can the Fed tolerate that the market completely ignores its signals is the question that should be on everyone's mind? Admittedly, the Fed's - as well as other central banks' - behaviour and about-face guidance over the past few years is a major cause for this credibility crisis. Nevertheless, that surely does not mean that it has to accept the current situation. The fact that Fed members have now become more vocal about their balance sheet plans is important, especially as the mix of central bankers is poised to change. Whilst Fed Chair Janet Yellen has a track record of adequately preparing markets for any policy shifts, her term expires next year and a new Fed leader may not be so successful at gently easing Wall Street into tighter lending conditions.



The Fed also discussed the implications of the strength in equity prices, with some members saying that prices were "quite high" relative to standard valuation measures. A few said that they thought values were being driven more by hopes for corporate tax cuts or higher risk tolerance, than expectations of stronger growth. And whilst the initial equity market reaction was muted, a big morning rally in US stocks – that followed a strong ADP payroll release - soon evaporated, with the US Dow Jones Industrial average sinking 41 points on the day (after rising as much as 198 points earlier in the session!).

Richmond Fed Jeffrey Lacker is Out!

Richmond Fed President Jeffrey Lacker (a non-voter on the FOMC this year) resigned abruptly last Tuesday as he announced his role in the unauthorized disclosure of information to Medley Global Advisors about policy options that the central bank was considering back in 2012 (o*fficials might only be allowed to disclose private information to GS, and NOT Medley Global Advisors*). However, his explanation suggested he was confirming facts the Medley analyst already knew. Even after the scandal cut short the career of one top Fed official, the answer to the most important question remains a mystery: WHO did the initial leaking? (the original leaker may ultimately never be revealed). Lacker's carefully worded statement, distributed by his attorney, said he "*crossed the line to confirming information that should have remained confidential*." The investigation into Lacker has concluded and no charges will be brought against him, the attorney said. He also added the Medley analyst "*introduced into the conversation an important non-public detail"* about one of the policy options under consideration. Lacker says he did not decline to comment "*and the interview continued*." His statement does not suggest that he tipped the Medley analyst initially. Indeed, the Fed board's own investigation said "a few Federal Reserve personnel" had contact with the Medley analyst.

It was a sudden career stop for a Fed president who was frequently in opposition to the Fed board consensus on interest-rate policy (making him my favourite Fed governor!), and the news will likely revive questions in Congress about the value of the central bank's discretion and transparency. "*The story is not over today*," said Andrew Levin, a professor at Dartmouth College who was previously a special adviser at the Fed board and helped then-Vice Chair Janet Yellen develop the Fed's policy on external communication. "*There are a number of distinct details that suggest that Lacker was not the main source of information*." Whatever the outcome, the timing of the scandal is not good for the Fed. House Republicans have floated several bills in recent years aimed at curbing the Fed's independence and forcing the central bank to disclose and abide by a policy rule. At the same time, many lawmakers were big fans of Lacker, a bailout opponent and consistent monetary policy hawk who was worried that leaving rates too low for too long would fuel inflation.

Moving to Europe, a quick take on Mario Draghi's speech at the Goethe University in Frankfurt, Germany yesterday morning, and its implications on European rates: The European Central Bank's head moved to end speculation that the ECB will begin to dismantle its experiment with negative interest rates before the end of the year, disappointing bankers who say the policy is eating into their profit margins. Mario Draghi, ECB president, tried to dispel rumours that the eurozone's monetary policymakers would start to raise their deposit rate (currently at -0.4%), saying that the negative side-effects of the policy "*have so far been limited*". Speculation had mounted in recent weeks that the ECB could renege on a commitment to keep interest rates at current, or lower, levels until the end of its programme of mass bond buying, known as quantitative easing. When asked earlier this month if the ECB could raise rates before the conclusion of QE, Mr Draghi failed to provide a clear response - stoking expectations of a rise in the deposit rate in the autumn. While some members of Mr. Draghi's inner circle have insisted that the bulk of the council would prefer to stick with plans to keep rates unchanged until the end of QE, one of the ECB officials closest to the president, Benoît Coeuré, broke ranks last week and raised the possibility of scrapping negative rates before bond buying concludes.

QE purchases are planned until the end of 2017, with the ECB buying € 60 billion a month of financial assets between now and December. The programme is expected to continue into the first half of 2018, though the pace of purchases may slow. "*The impact [of negative rates] on bank profitability has been offset by the positive side-effects of easier financial conditions*," Mr Draghi noted, adding that the ECB's commitment to low interest rates "*reflects exactly this assessment of side-effects*". Some of the 25 members of the council, including the heads of the French and Austrian central banks, have pushed for Mr. Draghi to reconsider the sequencing of its exit from its aggressive monetary easing. Jens Weidmann, president of the Bundesbank and one of the council's most vocal hawks, disagrees! He said yesterday in Berlin that low interest rates were harming banks' profitability. Mr Weidmann said it was "legitimate" for the ECB to begin to head for the exit and "*consider monetary policy normalisation*", including "*how it could adapt its communication in advance*".

Last, but not least, traders will shift focus this afternoon to the all-important US payroll release** (3:30 pm Bahrain time). Bloomberg consensus is for March payrolls rising by 180,000 (versus 235,000 in February). As always, it will also be worth keeping a close eye on the other important elements of the report, namely the unemployment rate (expected to stay unchanged at 4.7%, or possibly decline one-tenth to 4.6%), average hourly earnings (+0.2% mom /+2.7% yoy), the participation rate (last at 63.0%) and average weekly hours (expected unchanged at 34.4).

***Employment growth had been running a little hotter than expected recently, but March finally saw a sharp drop off in the headline gain, possibly due to the unfavorable weather during the month. Non-Farm payrolls increased only 98,000 during the month, with a downward revision of 38,000 jobs to the prior two months. While the soft number will have a market reaction, the average of gain in 2017 still remains solid at 180,000 monthly. The unemployment rate edged down to 4.5%, despite labor force participation remaining at 63.0%, thanks to a strong rise in the household employment survey. Average hourly earnings gained a trend-like 0.2% m/m and 2.7% y/y, with a one-tick upward revision to the prior month.*

Market reaction has so far been muted, with 10-year UST yields down 2 bps to 2.30%, EUR/USD almost unchanged at 1.0630 and US stocks flat on the day.

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