Weekly Market Summary

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Who Let the Hawks Out ?! Hike, Hike, Hike, ...

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Let me start by wishing our valuable readers peace, serenity and utmost happiness for these last 10 days of Ramadan!! Also Eid Al-Fitr Mubarak & "Kul 3Am Wa Entom Bi-Khair" in advance !!

We have long argued - in previous weekly economic commentaries – that the US Federal Reserve's credibility was at stake, more so in the past two years, given that members of the Federal Open Market Committee ("FOMC") had consistently overpromised on growth/inflation forecasts and rate hike assurances (Fed projections in late 2014 and late 2015 were for four rate hikes over the next 12 months, versus the actual one and done 25 bps hike outcome for 2015 and 2016!). Nine full years after the big economic crash the US economy continues to send confusing signals (though clearly more biased to the bullish side), leaving Fed's policy makers undecided and/or little united as to what that mean. Still, such sounds awkward when the one thing investors want from Fed's meetings is clarity with regards to the forward path of interest rates! Under those circumstances, the Fed was bound to disappoint whatever it chose to do: Many commentators felt that surprise rate hikes - poorly priced by markets going into the Fed rate announcement – risked shocking financial markets and sparking steep sell-offs in bond and equity markets. However a Fed on hold, after several warning shots on rates in Fed speeches, could inevitably confirm the notion that the Fed always chickens out when sensitive policy decisions have to be implemented (*why talk the talk, if you can't walk the walk?!).*

Our view on this matter has always been markedly different: There is no perfect time - there will always be some uncertainties in the data or on the political/geopolitical front. Nonetheless, the Fed cannot and should not run a very loose monetary policy in the face of robust payroll data, a record-low unemployment rate, rising business and consumer confidence, as well as easing financial conditions and skyrocketing equities. There is a window of opportunity for the Fed to continue normalizing, and it surely must take it before matters get out of control! Much to our pleasant surprise, this notion seems to be the Fed's broad line of thinking and consensus for 2017! Fed Chair Janet Yellen is braving opposition inside and outside the U.S. central bank (especially those who advocate keeping rates on hold and giving the economy more room to run), warning that waiting too long to raise US interest rates and/or keeping in place large liquidity injections/balance sheets threatens to overheat the US economy, repress market volatility and distort the healthy functioning of markets (short periods of stability that are followed by mounting threats of future financial instability)!

With their new founded strategy well-advertised, the Fed went ahead with a quarter-point rate hike to their benchmark interest rate last Wednesday, June 14th (Fed funds rate raised to 1.00% - 1.25%), the third such increase in six months and kept a message of confidence in the strengthening of the U.S. economy. The Fed's decision was nearly unanimous. Eight members of the deciding Federal Open Market Committee voted in favour of the rate increase. Only one, Neel Kashkari, the president of the Minneapolis Federal Reserve, voted against it. The rate hike "*reflects the progress the economy has made and is expected to make toward maximum employment and price stability*," Fed Chair Janet Yellen said in the ensuing press conference, arguing that a gradual path of rate increases was the best way to avoid a more damaging scenario for the economy. The Fed also laid out plans to begin rolling back the US$ 4.5 trillion balance sheet it accumulated in an effort to prop up the economy after the financial crisis. Key US economic data - released earlier in the day – had shown metrics of inflation and consumer spending coming in below the Fed's target and market expectations (latest core CPI reading shows US inflation – ex-food and energy - running at +1.7% YoY, well below the Fed's 2% target!), convincing some that the Fed should put off future interest rate hikes (it would have been unthinkable a year or two ago for the Fed to hike rates while at the same time at least partially dismissing a string of disappointing inflation and retail sales figures! Yet that's exactly what happened this week). But Fed board members hardly altered their projections for the economy and their forward rate projections were in line with what they had forecasted at their March 15th meeting.

In her press conference, Janet Yellen played down a softening of price pressures in the last few months and voiced confidence the central bank was on course to hit its 2% inflation goal. "*It is important not to overreact to a few readings, and data on inflation can be noisy*," she told reporters. FOMC members continue to predict one more rate increase this year, as well as three rate increases next year. Their projections also indicate that the Fed expects the economy to grow 2.2% in 2017 and 2.1% in 2018 - far below the 3% growth that the Trump administration is targeting. Board members did lower their estimates for the unemployment rate and inflation, metrics that have consistently fallen below their expectations.

This latest Federal Reserve's renewed assertiveness over interest rate policy has some investors sceptical and thinking the approach may be unwise! To those, whilst markets are buoyant, the labour market looks tight and economic growth is solid - both retail sales and inflation have printed below expectations in the past two (or three) months. And yet the Fed elected not only to raise interest rates again, but also maintained its prediction of another increase later in 2017 and unveiled an unexpectedly aggressive plan to begin unwinding its US$ 4.5 trillion balance sheet as early as this year. "*I am not convinced, and the markets are not convinced*," says Krishna Memani, chief investment officer at OppenheimerFunds. "*The surprise was not the rate increase but the fact they were as clear as they were about the balance sheet move, which was a bit of a surprise. They are hewing to the line that they are data-dependent, but it does not seem they are that data-dependent*." The headline market reaction to the Fed's announcement and subsequent press conference by central bank chair Janet Yellen was fairly muted. The 10-year Treasury yield, which had enjoyed a powerful rally after disappointing economic data, sold off slightly, but remained close to a seven-month low of 2.14% (last 2.17%). Moreover, the US yield curve - the shape made up of Treasury bond yields of varying maturities (usually 10s over 2s) - flattened further, approaching a decade low. The recent narrowing between short and long-dated yields indicates that investors think the economic outlook is dimming, with Bank of America Merrill Lynch analysts arguing that the US yield curve is a good proxy for a "*Fed policy mistake trade*". The US dollar reversed all of its initial losses, thanks to rising short-term bond yields, which are sensitive to interest rates. It was firmer this morning again, trading at 111.30 and 1.1180 versus the Japanese Yen and Euro respectively. Mind you that this week saw an apparently startling transformation in the reaction function of not just the US Fed, but also the Bank of England MPC!! After years of surprising on the dovish side, the Bank of England too was more hawkish than expected at yesterday's gathering, when it stunned markets by revealing that it nearly hiked rates, retaining an unchanged policy setting by a narrow 5-3 margin. This was unexpected coming on the heels of generally poor growth data and suggests that the Bank's orientation has shifted very much toward the risks posed by high inflation (official figures showed May inflation hitting an annual rate of 2.9%, its highest level in nearly four years and much higher than market consensus!). UK short and long-term yields soared as equities suffered.

Last, but not least, a quick recap. of oil price movements in the past 72 hours: Oil slipped to the lowest since November as weaker demand at the start of the summer driving season led to another increase in gasoline stockpiles. Gasoline inventories rose 2.1 million barrels last week, and diesel supplies also increased, according to the Energy Information Administration. Crude inventories fell by 1.66 million barrels, less than the 2.45 million barrels that analysts surveyed by Bloomberg had expected. Adding to the market pessimism, the International Energy Agency said new production from OPEC's rivals will be more than enough to meet growth in demand next year, overwhelming the oil group's efforts to reduce supplies. Oil has extended its slump below $50 a barrel as concerns grow that rising U.S. supplies will offset the production curbs by the Organization of Petroleum Exporting Countries and allies including Russia. Output at major American shale fields will reach a record in July, according to the EIA. OPEC should have agreed to cut an additional 1 million barrels a day for 90 days when the group met last month to bring the market back into balance, Gary Ross, founder of PIRA Energy, a unit of S&P Global Platts, said in London. West Texas Intermediate for July delivery settled at $ 44.46 a barrel on the New York Mercantile Exchange yesterday, the lowest close since November 14th.

One thing is for sure: If history is a guide, crude oil needs to get its rally game on soon for more Federal Reserve rate hikes to materialize in coming year! After all, lower "black gold" prices are a good proxy for the new lack-of-inflation normal. Prices are declining on the back of rapidly advancing technology, boosting production and substitutes while reducing incremental demand. Whether oil prices end up never recovering from current depressed levels or otherwise rise more and sooner than markets believe remains anyone's guess really. I surely wish the latter happens !!

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