Weekly Market Summary

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When an Attack on Saudi Oil Facilities Matters More than a Fed Rate Cut!!

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This week's focus - in financial markets - was expected to be solely on the outcome of the September 18th FOMC meeting, and to a lesser extent on the reckless "Fed bashing" presidential tweet that would subsequently follow. Instead, all eyes and ears remained glued to last weekend's attacks on Saudi soil. What every strategist previously feared had suddenly materialised: Middle Eastern geopolitics coming back with a vengeance to hit the oil market after an attack penetrated the defences of Saudi Arabia's massive Abqaiq oil processing facility, the heart of the Kingdom's oil production and export infrastructure, causing an unknown amount of damage!

Starting with the weekend drone attacks on Saudi oil facilities, investors woke up last Saturday to news that Saudi Arabia's oil production had been cut by half after a group of explosive drones struck at the heart of the Kingdom's energy industry and set the world's biggest crude-processing plant ablaze - an attack instantly blamed on Iran by Michael Pompeo, the top U.S. diplomat. The US Secretary of State, also a former director of the CIA, said in a tweet there is no evidence the attacks came from Yemen and blamed Iran directly, although he did not offer evidence for that conclusion. President Donald Trump initially spoke with Saudi Crown Prince Mohammed Bin Salman by telephone and later commented on his twitter account that "*there is reason to believe that we know the culprit, are locked and loaded depending on verification, but are waiting from the Kingdom as to who they believe was the cause of this attack*". And whilst Iran-backed Houthi rebels in Yemen - who have launched several drone attacks on Saudi targets in the past - claimed responsibility for the assault on the Kingdom's Abqaiq plant, reports soon emerged that Saudi and U.S. officials were investigating the possibility that cruise missiles were launched from Iraq, which is much closer than Yemen (In past days, the Saudi military has come out claiming that the drones and missiles were made by Iran and came from a "*northerly*" direction, ruling out Yemen as a launch site, but stopping short of saying the strikes were launched directly from or by Iran).

With close to 5.7 million barrels per day of output being suspended - as confirmed by an early Saudi Aramco statement - and operations in Abqaiq and Khurais fully halted, the latest drones / missiles strike had abruptly highlighted the vulnerability of the network of fields, pipeline and ports that supply 10% of the world's crude oil. Indeed, a prolonged outage at Abqaiq - where crude from several of the country's largest oil fields is processed before being shipped to export terminals - would assuredly shock global energy markets over the coming days/weeks!

And Initial Shock it Was!!

When markets opened early morning on Monday 16th September, crude oil futures instantly surged by as much as 15% & 20% for WTI and Brent prices respectively (WTI: 54.85 -> 63.35 & Brent: 60.10 -> 71.95) - as traders weighed heightened risks and intense concerns about the growing instability in the world's most important crude-producing region. However, prices soon started reversing course as Saudi Aramco sought to reassure the oil market that it would still be able to keep customers supplied for several weeks by drawing on a global storage network (it holds millions of barrels in tanks in the Kingdom itself, plus three strategic locations around the world: Rotterdam in the Netherlands, Okinawa in Japan, and Sidi Kerir on the Mediterranean coast of Egypt). The U.S. Department of Energy also jumped to the rescue, saying it is prepared to dip into the Strategic Petroleum Oil Reserves if necessary to offset any market disruption. The International Energy Agency, responsible for managing the oil reserves of the world's industrialized economies, added it was monitoring the situation, but the world was well-supplied with commercial stockpiles. Further confirmation on Tuesday afternoon that Aramco had already restored half of the crude production lost in previous days, with the remaining missing output expected to be fully restored before the end of September, provided the ultimate impetus for the follow-up leg lower in crude (WTI oil last trading at $ 58.62 and Brent at $64.80).

Then, on Wednesday evening, the US Federal Reserve met and - as widely expected - chose to lower the target range for the Fed funds rate by 25 bps to 1.75%- 2.00%, the second cut this year. Fed Chair Jerome Powell – in his ensuing press conference - said that "*moderate*" policy moves should be sufficient to sustain the US economic expansion and counter weak global growth and trade uncertainties. Powell also added that policy makers did not expect to need deep rate cuts, despite relentless public pressure to further reduce rates from President Trump, though he left the door open to a more extensive sequence of cuts should those be needed in the future. US rates were little changed after the Fed announcement with yields on 5-year and 10-year swap rates settling at 1.57% and 1.65% respectively (shorter tenors saw a 3-7 bps jump in yields). Stocks, on the other hand, wobbled initially (with the Dow Jones Industrial Average dropping 170 points from pre-Fed announcement levels) after the Fed's policy statement showed officials were not in agreement about the prospect of further rate cuts in 2019, then staged a late-session rebound when Fed Chair Powell confirmed that the US economic outlook remains bright.

Other important takes from this week's FOMC meeting:

- The median forecast among its rate-setting committee is that rates would be at the same level at the end of 2020 (coming from the same body that projected – at its December 19th, 2018 meeting - two rate hikes for 2019! Whoo Ah!)

- The Fed statement drew an immediate attack from President Donald Trump, who tweeted: *"[Fed chairman] Jay Powell and the Federal Reserve Fail Again. No "guts," no sense, no vision! A terrible communicator!*" (time to listen to that whistle-blower's complaint about the President's promises to foreign leaders! ☺)

- Amid rising disagreement among the Federal Open Market Committee over changing economic conditions, there were three dissents: Jim Bullard, president of the St Louis Fed, preferred a steeper cut of 50 basis points (your next Fed Chair if President Trump gets re-elected in 2020!). As in July, Esther George and Eric Rosengren voted to keep the rates unchanged. "*Sometimes the path ahead is clear, and sometimes less so*," Mr Powell said in his post-meeting press conference. "*This is a time of difficult judgments, as you can see, disparate perspectives. I really do think that's nothing but healthy*."

- The interest the Fed pays on excess reserves was dropped to 1.80%, rather than the 1.85% that would have been expected to maintain the target policy That was partly justified by the fact that the Fed meeting followed several days of market disruptions, as returns on overnight lending spiked as high as 10% on Tuesday and remained elevated on Wednesday and Thursday - despite the NY Fed's large injection of temporary liquidity to financial markets (in excess of $ 200 billion over the 3-day period!). Below we reproduce FT's coverage in relation to this developing story (for market lovers only!)

**During the era of quantitative easing, the Fed injected money into the financial system by buying Treasury and mortgage bonds from banks, which then held that cash as excess reserves with the central bank. Those reserves peaked at $2.9 trillion in July 2014, and then began to fall. That is because the Fed began shrinking its balance sheet - by ceasing its bond purchases. At the same time, the amount of Treasury debt in circulation has expanded to fund the increasing US budget deficit. When repo rates spike, as they did this week, that is a sign that the financial system does not have enough cash on hand. Such an outcome was foreseen a couple of years ago, when Lorie Logan, head of market operations and market analysis at the New York Fed, said in May 2017: "Upward pressure on overnight interest rates is the most direct indicator that reserves are becoming scarce." The current figure of $1.4 trillion in bank reserves held at the Fed appears large, but much of it is tied up because of regulatory and liquidity requirements, according to analysts. That leaves little spare cash for banks to deploy when it becomes more difficult to borrow money in the repo market.*

This week's spike in rates reflects two forces: Companies have pulled cash from money market accounts to pay corporates taxes for their September 15th deadline. Meanwhile, banks have been flooded with recent sales of Treasury debt that they need cash to pay for. The end result has been a spike in the overnight repo rate from about 2.25% to a peak of 10% … "How significant is this? Extraordinarily," said a repo specialist at a US bank. "The Fed [lost] control of monetary policy." Another measure of overnight borrowing costs, the secured overnight financing rate, or SOFR, also climbed to highly elevated levels. It reached 5.25% on Tuesday, well above the Fed's target for short-term rates. The rise in that gauge is significant because it is meant to replace Libor as the benchmark for trillions of dollars of corporate loans, credit cards and derivative contracts. Analysts said the Fed's dramatic intervention should be seen as a valve meant to release pressure on the repo market, in which banks and funds provide Treasuries and other securities in exchange for cash in transactions that reverse overnight … Many in the market think a lasting solution will require the central bank to start expanding its balance sheet once more, albeit on a modest scale. **(Time for helicopter money!)**

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