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Weekly Commentary

by Timothy Johnson
Head of Total Return Multi-Sector
timothy.johnson@fftw.com

Central banks still matter

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Key takeaways

- Message from the March FOMC meeting revealed a Committee that is likely to take a more cautious approach to policy normalization
- The Committee continues to anticipate above-trend growth this year and next, and a gradual return of inflation to two percent
- June remains a possibility for the timing of an additional rate increase

Full commentary

Time and time again investors hear the refrain, "don't fight the Fed" and take positions in opposition to their communications. Importantly, to fight the Federal Reserve Bank, one must assume their communications are clear. Leading up to last week, Chairwoman Yellen took great pains over several months to communicate the Committee would be data dependent, the labor market was very close to full employment and fully healed since the financial crisis of 2008, and that improvements in a comprehensive set of inflation measures were necessary to continue the rate normalization begun in December 2015. Market participants assumed the financial market volatility experienced the first six weeks of the year would prevent a hike at the March meeting but that solid progress towards both the full employment and price stability mandates would solidify expectations for a further rate hike at the June meeting.

Instead, message from the March Federal Open Market Committee (FOMC) meeting revealed a Committee that is much more attuned to risks emanating from abroad and likely to take a much more cautious approach to policy normalization. For example, while the policy statement did not bring back a full assessment of the risks to the outlook, it nevertheless noted that "global economic and financial developments continue to pose risks". The Chair elaborated on these risks in her press briefing, highlighting a number of countries experiencing slower growth. Despite the firming in inflation over recent months - year over year core personal consumption expenditure rose to 1.67% in March, above the 1.6% end of year level in the Summary of Economic Projections - the policy statement continues to emphasize that inflation is running below the Committee's objective, and that it is expected to remain low in the near term. Moreover, at 4.9%, the U-3 unemployment rate had fallen to the Committee's projected long run level, until they lowered it for the third time in 12 months to 4.8%.

Judging from the median economic projections, the Committee continues to anticipate above-trend growth this year and next, and a gradual return of inflation to two percent. However, to achieve these outcomes, Committee members anticipate a notably flatter path of policy rates. The median policy rates projected for year-end 2016 and 2017 each came down by 50 basis points, to reflect 50 basis points of policy tightening this year and 100 basis points next year. In response, yields fell across the Treasury curve, most notably in the shorter-term maturities as investors covered short Treasury positions. In addition, global equity markets rallied, credit spreads narrowed, the trade weighted US dollar weakened, oil prices and breakeven inflation rates rose, and various volatility measures subsided.

Some have suggested the more the Fed tries to communicate, the more confused investors become. However, as we have stressed repeatedly, the FOMC must consider the second and third order effects of its policy in a world of essentially unimpeded global capital flows and increasingly global price competitiveness. While domestic data surely improved during the intermitting period, the period was also characterized by: 1) significant spikes in equity, foreign exchange and fixed income market volatility to levels not seen since the Lehman crises; and 2) monetary easing by the Reserve Bank of New Zealand, European Central Bank, People's Bank of China, and the Norges Bank. As a result, some acknowledgment of the fragile global growth environment and related risks to the US economy was surely warranted at the FOMC March meeting. As for the timing of an additional rate increase, June remains a possibility. The Committee will want to see that the recent firming of inflation does not prove short-lived, and that inflation expectations continue to move higher. They will also seek confirmation that domestic growth is not slowing to a below-trend pace. In this regard, some of the key variables to watch include payrolls, consumer spending – which has been running on the soft side recently – and surveys of service sector activity. In addition, a rebound in global growth momentum reflected in indicators such as global PMIs would be supportive of further US rate normalization.

This week's market developments

Monday, March 14
- Japan Machine Orders growth increased to 15.0% m.o.m. (s.a.) for January
- Eurozone Industrial Production growth increased to 2.1% m.o.m. (s.a.) for January

Tuesday, March 15
- Japan Tertiary Industry Index growth increased to 1.5% m.o.m. (s.a.) for January
- US Advance Retail Sales growth decreased to -0.1% m.o.m. (s.a.) for February
- US Empire State Manufacting Survey increased to 0.6 for March

Wednesday, March 16
- UK ILO Unemployment Rate remained at 5.1% for January
- US Housing Starts increased to 1,178,000 units (s.a.a.r.) for February
- US CPI growth decreased to 1.0% y.o.y. for February
- US Industrial Production
- growth decreased to -0.5% m.o.m. (s.a.) for February

Thursday, March 17
- US Conference Board Leading Index increased to 0.1% m.o.m. (s.a.) for February

Friday, March 18
- US University of Michigan Consumer Sentiment Index (preliminary estimate) decreased to 90.0 for March

Source: Bloomberg, as of end March 18, 2016

Central Bank watch

	Last move	Date of move	Current policy rate	Implied 3m rate on March 2016 Interest Rates Futures Contract	Next meeting
Fed	+25 basis points	December 16, 2015	0.25 % - 0.50 %	0.45 %	April 27, 2016
ECB	-5 basis points	March 10, 2016	0.00 %	-0.18 %	April 21, 2016
BoJ	-20 basis points	February 16, 2016	-0.10 % - 0.00%	0.07 %	April 28, 2016
BoE	-50 basis points	March 5, 2009	0.50 %	0.60 %	April 14, 2016

Source: Bloomberg

Next week's market developments

Monday, March 21

- US Existing Home Sales are expected to decrease to 5,310,000 units (s.a.a.r.) for February
- Eurozone Consumer Confidence (advance estimate) is expected to improve to -8.3 for March

Tuesday, March 22

- Japan All Industry Activity Index is expected to increase to 1.9% m.o.m. (s.a.) for January
- Eurozone Markit Composite PMI (preliminary estimate) is expected to remain at 53.0 for March
- UK CPI growth is expected to increase to 0.4% y.o.y. for February
- Germany IFO Business Expectations Survey is expected to increase to 99.5 for March
- Germany ZEW Economic Growth Expectations Survey is expected to increase to 5.4 for March

Wednesday, March 23

- US New Home Sales are expected to increase to 510,000 units (s.a.a.r.) for February

Thursday, March 24

- UK Retail Sales growth is expected to decrease to -0.7% m.o.m. (s.a.) for February
- US Durable Goods Orders growth (preliminary estimate) is expected to decrease to -3.0% m.o.m. (s.a.) for February
- Japan CPI growth is expected to increase to 0.3% y.o.y. for February

Source: Bloomberg, as of end March 18, 2016

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