A BNP Paribas Investment Partner

Weekly commentary

Strike one...

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Key takeaways

- Expectations for an interest rate hike at the June 15 Federal Open Market Committee (FOMC) meeting quickly evaporated following Friday's weak payroll report.
- Recent events make the June/July interest rate hike debate increasingly controversial.
- A pause at the June meeting would be the fourth sequential meeting without a change since the December interest rate hike.
- Current conditions lead us to question the appropriateness of Fed forecasts, particularly as the span of time between the first and second hike lengthens.

Full commentary

Expectations for an interest rate hike at the June 15 Federal Open Market Committee (FOMC) meeting quickly evaporated following Friday's weak payroll report. Federal Reserve System (Fed) officials had been carefully preparing markets for a potential tightening of monetary policy by categorizing June as a "live" meeting. Friday's disappointing report suggests that the labor market has softened even after compensating for the Verizon labor strike which negatively impacted the payrolls by an estimated 35 thousand jobs in May. Sluggish job gains may warrant continued caution from Fed officials as they debate the appropriateness of monetary policy next week.

Recent events make the June/July interest rate hike debate increasingly controversial. Advocates for proceeding with policy tightening tend to focus on the diminishing returns of low interest rate policies and risk of an unintended inflation overshoot. They argue that the economy can withstand another step away from zero interest rate policy. Dissenters declare the global economy as weak and increasingly at risk from U.S. policy divergence. They cite the absence of inflationary pressures as unsupportive of monetary policy tightening. Markets have taken the recent ebb and flow of policy expectations in stride. We have come a long way since the Bernanke taper tantrum disrupted global markets. Fed communication has improved considerably enabling markets to digest a full cycle of taper along with the first tightening in nearly 10 years with barely a ripple.

A pause at the June meeting would be the fourth sequential meeting without a change since the December interest rate hike. In previous meetings, the Fed was clearly concerned that global turmoil would negatively impact the U.S. economic recovery. That concern faded as global markets calmed and second quarter domestic data showed signs of firming. Fed officials then strived to ready markets for a potential resumption of the tightening cycle by the June meeting. Recent domestic data, however, fail to support arguments for policy tightening. While market conditions are very similar to the day before the last FOMC meeting in April with equity markets mostly unchanged, credit spreads modestly wider, and the U.S. dollar is slightly weaker, the trend in economic data has deteriorated. Softer labor markets, trendless inflationary pressures, and weaker purchasing manager surveys (ISM) hardly warrant concern of an overheating economy.

In fact, current conditions lead us to question the appropriateness of Fed forecasts, particularly as the span of time between the first and second hike lengthens. Initially, "gradual removal of policy accommodation" was interpreted as meaning roughly every other meeting but that was short lived. The duration of the pause has now been stretched to nearly six months leading many to conclude that Fed forecasts are overly optimistic and inconsistent with the data. Markets have persistently disagreed with the ability of the Fed to normalize policy in the current environment. The gap closed modestly following a marginal reduction in Fed forecasts in March but has once again widened in response to weak data. It will be interesting to see if the Fed's forecasts have also evolved since the March SEP (Summary of Economic Projections) and if the gap can persist.

So what metrics are driving Federal Reserve officials to consider another tightening measure? FOMC Chair, Janet Yellen, previously indicated that the key prerequisites were continued progress toward full employment and a reasonable confidence that inflation was trending to target. In the early spring, we learned that international developments were also being considered as relevant. During the last week, several Fed officials indicated that the uncertainty surrounding the Brexit vote in June is also worthy of careful consideration. This broader focus on exogenous factors coupled with softer U.S. data appears to tip the scale in favor of an extended pause as impediments to tightening mount. However, the risk of a policy error cuts both ways. Extreme levels of policy accommodation for extended periods of time may lead to unintended consequences. ...stay tuned.

This week's market developments

Monday, May 30

- Eurozone Consumer Confidence Index (final estimate) was -7.0 for May
- Japan Industrial Production growth (preliminary estimate) decreased to 0.3% m.o.m. (s.a.) for April

Tuesday, May 31

- US Personal Income growth remained at 0.4% m.o.m. (s.a.) for April
- US Personal Spending growth increased to 1.0% m.o.m. (s.a.) for April
- US Consumer Confidence Index decreased to 92.6 for May

Wednesday, June 1

- Markit Eurozone Manufacturing PMI Index (final estimate) remained at 51.5 (s.a.) for May
- Markit UK Manufacturing PMI Index increased to 50.1 (s.a.) for May
- Markit US Manufacturing PMI Index (final estimate) increased to 50.7 (s.a.) for May
- US ISM Manufacturing Index increased to 51.3 (s.a.) for May

Thursday, June 2

- US ADP Employment Change increased to 173,000 m.o.m. (s.a.) for May

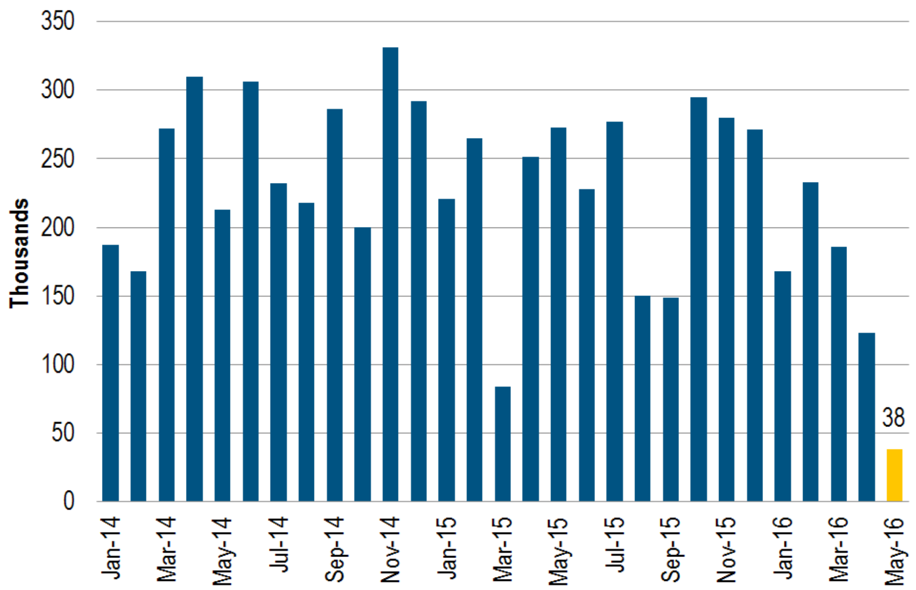
Friday, June 3

- US Change in Nonfarm Payrolls decreased to 38,000 m.o.m. (s.a.) for May
- US Unemployment Rate decreased to 4.7% (s.a.) for May
- US Factory Orders growth increased to 1.9% m.o.m. (s.a.) for April
- US Durable Goods Orders growth (final estimate) increased to 3.4% m.o.m. (s.a.)

Source: Bloomberg, as of end June 3, 2016

Chart of the week

U.S. Nonfarm Payrolls (month-to-month change)



Source: Bloomberg

Central Bank watch

	Last move	Date of move	Current policy rate	Implied 3m rate on September 2016 Interest Rates Futures Contract	Next meeting
Fed	+25 basis points	December 16, 2015	0.25 % - 0.50 %	0.46 %	June 15, 2016
ECB	-5 basis points	March 10, 2016	0.00 %	-0.20 %	July 21, 2016
BoJ	-20 basis points	February 16, 2016	-0.10 % - 0.00%	0.00 %	June 16, 2016
BoE	-50 basis points	March 5, 2009	0.50 %	0.55 %	June 16, 2016

Source: Bloomberg

Next week's market developments

Monday, June 6
- Germany Factory Orders growth is expected to decrease to -0.5% m.o.m. (s.a.) for April

Tuesday, June 7
- Germany Industrial Production growth is expected to increase to 0.7% m.o.m. (s.a.) for April
- Eurozone First Quarter GDP growth (final estimate) is expected to remain at 0.5% q.o.q
- Japan First Quarter GDP growth (final estimate) is expected to increase to 0.5% q.o.q

Wednesday, June 8
- UK Industrial Production growth is expected to decrease to 0.0% m.o.m. (s.a.) for April
- UK Manufacturing Production growth is expected to decrease to -0.1% m.o.m. (s.a.) for April
- Japan Machine Orders growth is expected to decrease to -3.0% m.o.m. (s.a.) for April

Thursday, june 9
- US Wholesale Inventories growth is expected to remain at 0.1% m.o.m. for April

Friday, June 10
- US University of Michigan Sentiment Index (preliminary estimate) is expected to decrease to 94.0 for June

Source: Bloomberg, as of end June 3, 2016