FFTW Weekly Commentary

FOR PROFESSIONAL INVESTORS

The Only Way Is Up!

By Alex Johnson
Head of Absolute Return
alex.johnson@fftw.com

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Key takeaways

- The Federal Reserve hike on Wednesday puts four hikes in 2017 as an increasingly likely outcome.
- The European Central Bank isn't hiking, but by discussing even the possibility reminds us that rates will rise there, too.

Full commentary

When writing a commentary, there is the ever-present danger in being usurped by facts, and this can lead to choices of language expressed in the conditional tense, hedged with caveats and ways in which we can hope to look thoughtful even while demonstrably wrong. With that said, the Federal Reserve (Fed) will hike the Fed Funds rate by 25 basis points on Wednesday, and nothing short of a weather catastrophe will change that – and we write this knowing that Washington, DC is expected to shut down on Tuesday owing to a huge snowstorm. This is done. It has been all-but preannounced. The probabilities of a Fed hike according to Bloomberg's assessment of Fed Funds is 96%, and 79 of 82 economists polled think the same. With respect to the other three, perhaps they misheard the question.

With this hike, we are now in a three-to-four hike year – and four is looking more likely. The Fed now seems keen to embark on rate normalization and absent a material change in the economic environment, it is not likely to be derailed. As we look beyond to 2018 and the Fed's dot plot, the median longer run forecast of the neutral rate of Fed Funds is 3%. The composition of the Federal Open Market Committee (FOMC) is likely to change appreciably over the next year, and this alone should be a dynamic affecting the risk premium – before considering fiscal easing and pro-cyclical policies pushing against already-rising inflation. As such, 3% looks on the loose side, but we should probably not expect a massive change in the dot forecast absent more clarity as to the budget. It has been a long time coming, but we are now indisputably in a rising rate environment in the US.

The bigger news may have been in Europe though, where the European Central Bank (ECB) kept rates on hold, and the current pace of quantitative easing in place. We expect to see tapering announced at the ECB's September meeting but there has been some chatter about sequencing – that is, the order by which tapering occurs and then rates are hiked. The market has assumed that tapering would occur first, and only once the quantitative easing (QE) program had finished completely would the ECB hike rates. In its statement, the ECB uses the phrase, "[w]e continue to expect them [rates] to remain at present or lower levels for an extended period of time, and well past the horizon of our net asset purchases." But when asked about the possibility of hiking rates before tapering, ECB President Mario Draghi said that he didn't, "want to speculate," and that it's an expectation; we expect them to remain at present or lower levels," but, "the Governing Council has decided to keep this forward guidance exactly as it stood before." This has had the effect of introducing doubt where little existed before, and there have been follow-up stories in the financial press. Likely, this is principally a reflection of costs to banks introduced by the negative deposit rate policy, and should not be confused with any discussion as to the timing of rate hikes designed to remove extraordinary policy accommodation. What it does do though is remind us that the days of that policy accommodation are numbered. The situation is more equivocal in Europe than in the US given the UK's imminent triggering of Article 50 formally signaling its intent to leave the European Union, as well as elections in the Netherlands, France, Germany, and probably Italy. But, this is a small but significant sign that for rates, the only way is up.

This week's market developments

Monday, March 6

- US Factory Orders growth is increased to 1.2% m.o.m. (s.a.) for January
- US Durable Goods Orders growth increased to 2.0% m.o.m. (s.a.) for January

Tuesday, March 7

- Germany Factory Orders growth decreased to -7.4% m.o.m. (s.a.) for January
- Eurozone 4th Quarter GDP growth (final estimate) remained at 0.4% q.o.q. (s.a.)
- Japan 4th Quarter GDP growth (final estimate) increased to 0.3% q.o.q. (s.a.)

Wednesday, March 8

- Germany Industrial Production growth increased to 2.8% m.o.m. (s.a.) for January
- US ADP Employment Change increased to 298,000 for February

Thursday, March 9

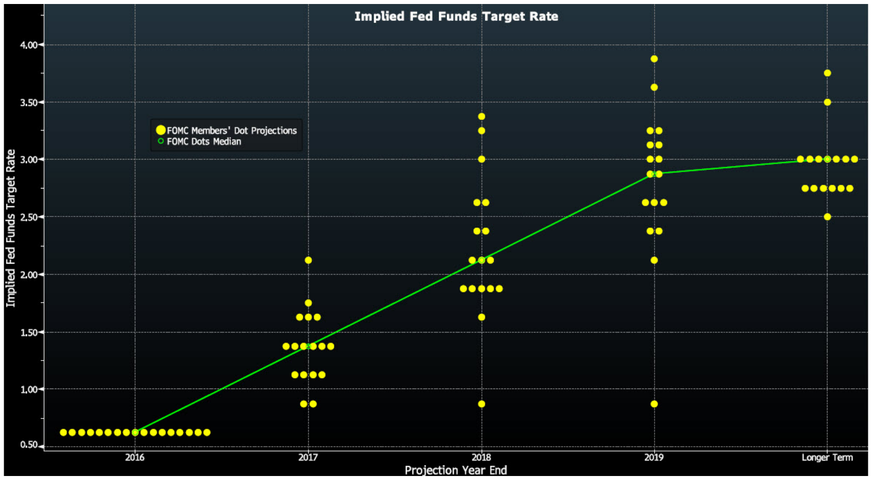
- US Initial Jobless Claims increased to 243,000 for the week ending March 4

Friday, March 10

- UK Industrial Production growth decreased to -0.4% m.o.m. (s.a.) for January
- UK Manufacturing Production growth decreased to -0.9% m.o.m. (s.a.) for January
- US Change in Nonfarm Payroll increased to 235,000 for February
- US Unemployment Rate decreased to 4.7% for February

Source: Bloomberg, as of March 13, 2017

Chart of the Week
Implied Federal Reserve Funds Target Rate



Sources: Bloomberg, as of December 31, 2016

Central Bank Watch

	Last move	Date of move	Current policy rate	Implied 3-Month Rate on June 2017 Interest Rate Futures Contract	Next meeting
Fed	+25 basis points	December 14, 2016	0.50% - 0.75%	0.97%	March 15, 2017
ECB	-5 basis points	March 10, 2016	0.00 %	-0.18%	April 27, 2017
BoJ	-20 basis points	February 16, 2016	-0.10 % - 0.00%	0.06%	March 16, 2017
BoE	-25 basis points	August 4, 2016	0.25%	0.38%	March 16, 2017

Sources: Bloomberg, as of March 13, 2017

Next week's market developments

Monday, March 13
- Japan Tertiary Industry Index is expected to increase to 0.0% m.o.m. (s.a.) for January

Tuesday, March 14
- US PPI Final Demand growth is expected to decrease to 0.1% m.o.m. (s.a.) for February

Wednesday, March 15
- US Empire Manufacturing is expected to decrease to 15.0 for March
- US CPI growth is expected to decrease to 0.0% m.o.m. (s.a.) for February
- US Retail Sales Advance growth is expected to decrease to 0.1% m.o.m. (s.a.) for February

Thursday, March 16
- Eurozone CPI growth is expected to increase to 0.4% m.o.m. (s.a.) for February
- US Housing Starts are expected to increase to 1,264,000 for February

Friday, March 17
- US Industrial Production growth is expected to increase to 0.2% m.o.m. (s.a.) for February
- University of Michigan Sentiment Index (prelim estimate) is expected to increase to 97.0 for March
- US Leading Index is expected to decrease to 0.5% m.o.m. (s.a.) for February

Source: Bloomberg, as of March 13, 2017

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