Weekly commentary

FOR PROFESSIONAL INVESTORS

Fed to “walk the talk”

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Key takeaways

- Economic data remains mixed with subdued hard activity data and strong confidence surveys
- Trump’s speech was more presidential but also scant on specifics and lacked any legislative time frame
- Federal Reserve (Fed) communication now strongly suggests a rate hike in March

Full commentary

While US economic data was rather mixed last week, closely followed speeches from the country’s two most important policy makers took centre stage and dominated market action. The bottom line was an 8Y high for 2Y Treasury yields and a new all-time high for the S&P 500.

The backdrop of economic data once again underlined the stark contrast between subdued hard activity data and strong confidence surveys. To start with, Q4 GDP growth was unrevised at just 1.9% q/q saar and real personal spending in January disappointed market expectations with a drop of 0.3%mom. Some of this weakness is possibly related to the slow start in tax refunds and solid price increases as headline PCE printed at 1.9%yoy, but the momentum in real personal consumption has clearly slowed over the last few months. Moreover, the trade deficit was wider than expected, durable goods and construction spending were weak, and auto sales slowed. At the same time, survey data remains strikingly optimistic. Business confidence as measured by the composite ISM suggests real GDP growth of above 3%yoy and Conference Board consumer confidence picked up to the highest level in 15 years.

This balanced data flow allowed investors to keep their eyes on Washington where President Trump addressed the joint session of Congress. The speech was scant on specifics and lacked any legislative time frame, but two points inspired markets to a positive interpretation. First, his tone was perceived as more presidential and, second, Trump emphasized job creation, lower taxes, fair trade, infrastructure investments, military spending and de-regulation. Whether and when he will be able to declare success on these fronts remains to be seen, but the convoluted calendar of Congress suggests that it will, at the very least, be a longer path for him to go in order to eventually “walk the talk”.

In addition to Trump’s remarks, a set of Fed speeches fuelled market volatility as rhetoric clearly shifted into hawkish territory. Board Governor Brainard noted that “it will likely be appropriate soon to remove additional accommodation” and Board Governor Powell thought that “the case for a rate increase in March has come together”. Furthermore, Fed Chair Yellen had the last word before the Fed’s blackout period began on Friday and struck an overall hawkish tone, arguing both that the economy is operating near or at capacity and that a too slow withdrawal of monetary accommodation now risks a more disruptive tightening cycle further down the road. It almost appeared as she was telegraphing a decision effectively already made by stating that at the next meeting the Federal Open Market Committee (FOMC) will likely conclude that “a further adjustment of the federal funds rate would likely be appropriate” if the economy evolved as expected. - *(continues p2)*

This week’s market developments

Monday, February 27

- US Durable Goods Orders growth (prelim estimate) increased to 1.8% m.o.m. (s.a.)
- Japan Industrial Production growth (prelim estimate) decreased to -0.8% m.o.m. (s.a.)

Tuesday, February 28

- US Wholesale Inventories growth decreased to -0.1% m.o.m. (s.a.)

Wednesday, March 1

- UK Markit Manufacturing PMI decreased to 54.6 for February
- US Personal Income growth increased to 0.4% m.o.m. (s.a.) for January
- US Personal Spending growth decreased to 0.2% m.o.m. (s.a.) for January
- US ISM Manufacturing increased to 57.7 for February
- US Construction Spending growth decreased to -1.0% m.o.m. (s.a.) for January

Thursday, March 2

- Japan National CPI growth increased to 0.4% y.o.y. (s.a.) for January

Friday, March 3

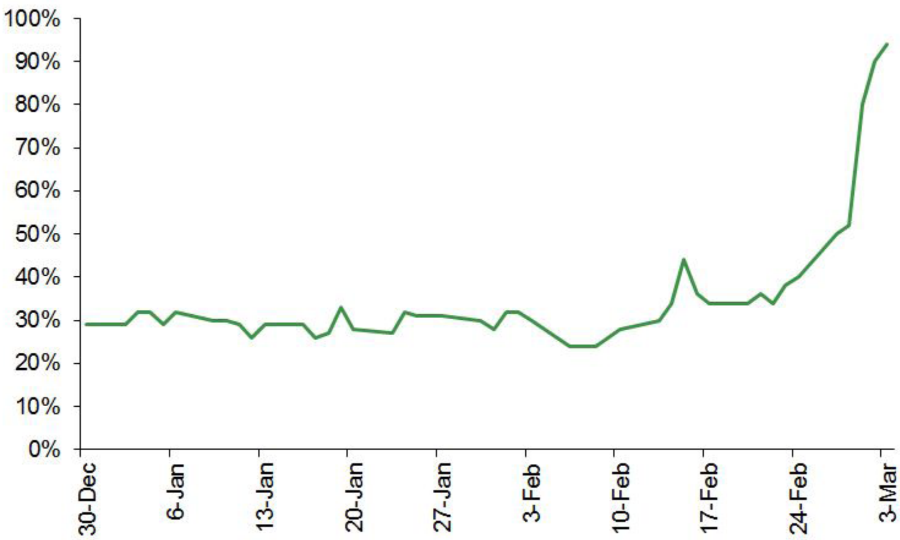
- US ISM Non-Manufacturing Composite increased to 57.6 for February

Source: Bloomberg, as of end March 6, 2017

The signalling is unambiguous: the FOMC targets the next step up in rates for March. The revival of animal spirits and the easing in overall financial conditions since the election, to which the strong rally in equity markets has markedly contributed, are probably two of the main drivers for the renewed urgency. Everything short of a disastrous disappointment in this week's labour market report should be the final piece in the puzzle for the Fed and allow them to "walk the talk" at their next meeting on March 15th. Markets agree and are pricing a rate hike probability of above 90%.

Chart of the week

Probability for 25 basis points rate hike at March FOMC meeting



Source: Bloomberg, as of March 3, 2017

Central Bank Watch

	Last move	Date of move	Current policy rate	Implied 3m rate on June 2017 interest rates futures contract	Next meeting
Fed	+25 basis points	December 14, 2016	0.50 % - 0.75 %	0.94 %	March 15, 2017
ECB	-5 basis points	March 10, 2016	0.00 %	-0.18 %	March 9, 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 %	0.39 %	March 16, 2017

Source: Bloomberg

Next week's market developments

Monday, March 6

- US Factory Orders growth is expected to decrease to 1.0% m.o.m. (s.a.) for January
- US Durable Goods Orders growth is expected to decrease to 1.0% m.o.m. (s.a.) for January

Tuesday, March 7

- Germany Factory Orders growth is expected to decrease to -2.5% m.o.m. (s.a.) for January
- Eurozone 4th Quarter GDP growth (final estimate) is expected to remain at 0.4% q.o.q. (s.a.)
- Japan 4th Quarter GDP growth (final estimate) is expected to increase to 0.4% q.o.q. (s.a.)

Wednesday, March 8

- Germany Industrial Production growth is expected to increase to 2.7% m.o.m. (s.a.) for January
- US ADP Employment Change is expected to decrease to 189,000 for February

Thursday, March 9

- US Initial Jobless Claims are expected to increase to 238,000 for the week ending March 4

Friday, March 10

- UK Industrial Production growth is expected to decrease to -0.5% m.o.m. (s.a.) for January
- UK Manufacturing Production growth is expected to decrease to -0.7% m.o.m. (s.a.) for January
- US Change in Nonfarm Payroll is expected to decrease to 190,000 for February
- US Unemployment Rate is expected to decrease to 4.7% for February

Source: Bloomberg, as of end March 6, 2017

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