FFTW

A BNP Paribas Investment Partner

Weekly commentary

Respite

March 28, 2016

by Ken O'Donnell
Head of Short Duration
kenneth.odonnell@fftw.com

Key takeaways

- Market sentiment has improved as threats of global economic turmoil have abated
- Recent developments suggest that the US may have avoided the global migration of disinflationary pressures
- Adverse developments in foreign economies continue to weigh on US markets
- Financial conditions have eased considerably in the last few weeks but the recovery remains fragile and susceptible to global economic developments

Full commentary

Are headwinds to policy normalization fading? Throughout the last year, the US Federal Reserve (Fed) has delayed tightening measures in response to numerous challenges including US dollar appreciation, disinflationary pressures, and global market turmoil. Recent data suggests that some of these forces may be in decline. After significant appreciation, the trade weighted US dollar appears to have stabilized, holding a defined range over the last year. Inflation data, which had been lagging in the recovery, has surprised to the upside potentially indicating the early stages of a trend to the Fed's target. Meanwhile, market sentiment has improved as threats of global economic turmoil have abated. Policy patience may be tested in the coming weeks if the green shoots of spring begin to flower.

The strong dollar has been the primary challenge of interest rate normalization with negative implications for export growth and corporate profitability. Export driven corporations have seen revenues fall as US goods became increasingly expensive in global markets and earnings at US based multinational firms have been negatively impacted by foreign currency translation. The current decline in corporate profitability remains a valid concern, though we may see a reversal of this trend in the coming year if the dollar remains stable. The impact of exchange rates on corporate profitability occurs with a discernable lag. This current period of weakening corporate profitability may be more reflective of the strong dollar trend which subsided over a year ago.

Recent developments suggest that the US may have avoided the global migration of disinflationary pressures. Core consumer price inflation has been running ahead of market expectations in the first quarter of 2016. While recent data can hardly be characterized as a trend, inflation data has been encouraging. Domestic providers of goods and services have had limited pricing power since the global credit crisis. A modest firming of price pressures would be interpreted as a positive indicator for the demand side of the economy. Market based measures of inflation expectations appear to have adopted a more sanguine view of US inflation dynamics, reversing the downtrend in breakeven inflation measures.

The US, however, is not immune to exogenous forces. Adverse developments in foreign economies continue to weigh on US markets. Global market turmoil roiled markets in the first quarter. Risk aversion swept over markets, driving equity prices lower and credit spreads wider. The dreaded R word ("recession") began to appear in leading publications. Fortunately, the correction was short-lived and a V-shaped retracement followed. This rather brief period exposed how susceptible US markets have become to shifts in global sentiment. Despite the fact that economic data has improved since prior year end, the Fed remained cautious in March, preferring to see additional confirmation that the storm has passed. Paradoxically, expectations for a delay in Fed tightening was the likely trigger for the shift in sentiment as risky assets have been negatively correlated with interest rates policy.

2016 appears to be unfolding in a similar pattern to prior years with year-end market optimism quickly replaced by broad based risk aversion. Market correlation increased as the flight to quality ensued. As the apex of negativity was reached, the pattern reversed and the steps were retraced. Financial conditions have eased considerably in the last few weeks but the recovery remains fragile and susceptible to global economic developments. While we respect the Feds restraint following the recent market experience, we are mindful of the fact that market surprises are symmetric – perhaps 2016 will surprise to the upside.

This week's market developments

Monday, March 21

- US Existing Home Sales decreased to 5,080,000 units (s.a.a.r) for February
- Eurozone Consumer Confidence (advance estimate) decreased to -9.7 for March

Tuesday, March 22

- Japan All Industry Activity Index Increased to 2.0% m.o.m (s.a) for January
- Eurozone Markit Composite PMI (preliminary estimate) increased to 53.7 for March
- UK CPI growth remained at 0.3% y.o.y for February
- Germany IFO Business Expectations Survey increased to 100.0 for March
- Germany ZEW Economic Growth Expectations Survey increased to 4.3 for March

Wednesday, March 23

- US New Home Sales increased to 512,000 units (s.a.a.r) for February

Thursday, March 24

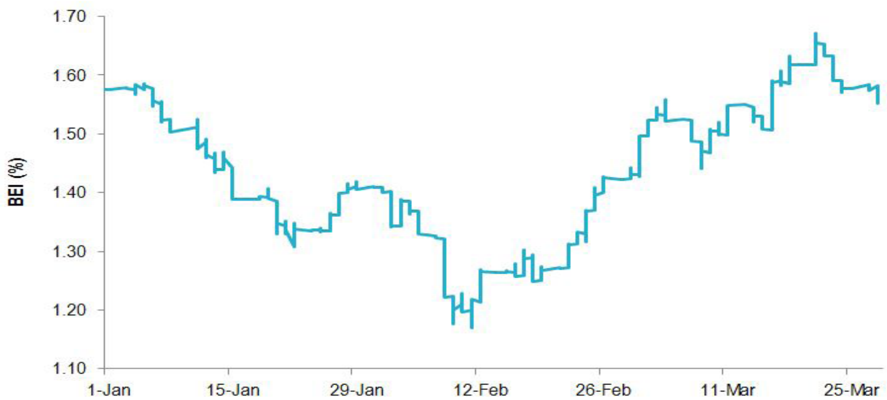
- UK Retail Sales growth decreased to -0.4% m.o.m (s.a) for February
- US Durable Goods Orders growth (preliminary estimate) decreased to -2.8% m.o.m (s.a) for February
- Japan CPI growth increased to 0.3% y.o.y for February

Source: Bloomberg, as of end March 25, 2016

Charts of the week

Markit CDX NA Investment Grade Index CDS Speads (top) and US 10-year Breakeven Inflation (bottom)

Source: Bloomberg



Source: Bloomberg

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 %	0.43 %	April 27, 2016
ECB	-5 basis points	March 10, 2016	0.00 %	-0.17 %	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 28
- US Personal Income and Personal Spending growth are expected to decrease to 0.1% and 0.1%, respectively for February
- Japan Retail Sales growth is expected to improve to -0.9% m.o.m. (s.a.) for February
- Japan Unemployment Rate is expected to remain at 3.2% for February

Tuesday, March 29
- Japan Industrial Production growth (preliminary estimate) is expected to decrease to -6.0% m.o.m. (s.a.) for February

Wednesday, March 30
- US ADP Nonfarm Employment growth is expected to decrease to 195,000

Thursday, March 31
- US Chicago Purchasing Managers Index is expected to increase to 50.5 for March
- Eurozone CPI growth is expected to improve to -0.1% y.o.y. for March

Friday, April 1
- UK Nationwide House Price growth is expected to increase to 0.4% m.o.m. (s.a.) for March
- UK Markit Manufacturing PMI is expected to increase to 51.2 for March
- US Change in Nonfarm Payrolls is expected to decrease to 208,000 for March
- US ISM Manufacturing is expected to increase to 50.7 for March

Source: Bloomberg, as of end March 25, 2016