So Many Questions

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- **Global markets headed for summer volatility**
- **Investors taken aback by Fed's willingness to raise rates soon**
- **A Fed rate hike more weighted against equities than bonds**
- **More policy action in the next weeks could spark a rally in the Nikkei**
- **Caution is warranted in Indian equity markets**

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The markets face a potentially rocky ride as we head towards June. To the shock of the market, the latest set of minutes from the Federal Reserve's regular policy making meeting gives a very heavy hint that the Federal Reserve may raise interest rates at their next meeting in June. Just days later the UK goes to the polls to vote on whether the UK should stay in the EU. We advise investors to prepare for risk of marked volatility in the markets.

The Fed wants to raise rates. The minutes from the last Fed meeting showed that voting members were keen to keep the door open to a policy move at the June meeting. The financial market that had priced barely a 10% chance of a rate rise in June now prices a 70%. How could the Fed have shifted its view so much? And how could the market have assessed the probability of a rate rise so wrongly? The first point to make is that the FOMC has always wanted to raise interest rates, but just had had an insufficient run of good excuses to do it. Something always came along to undermine the argument. So in a sense there was no shift of view.

Unfortunately the Fed have not helped their credibility with the tone of the previous set of minutes. That surprised the market with the degree to which they gave the impression that there was no urgency to raise interest rates. If there is a criticism of the Fed in recent times it is that the communication has been too short term and too emotional. The Fed at times has appeared to be too short term, too much like the markets instead of offering a considered long term perspective. The constant we heard was that the Fed remains 'data dependent'. How can an institution that is supposed to set policy for an economic cycle that lasts years be driven by a few weeks' data points?

Would the Fed really raise rates ahead of the Brexit vote in the UK? The Fed minutes of their last meeting mentions June six times, which suggests that a rate rise at the next meeting is the preferred option. However, if the Brexit vote is going all the way down to the wire one would expect/hope that the Fed would delay their likely rate rise. If the markets were hit with a US rate rise, followed by a vote in the UK to leave the EU one can only imagine the fall out in markets.

Will the Fed get it right by raising interest rates? Only time will tell, but to be honest this is a whole new experiment in monetary policy. No economic model can be built for current market conditions. That will only happen after the event. The Bank of Japan tried to raise interest rates on a number of occasions, proclaiming that the economy could take it and needed it and over occasion they had to cut rates again pretty promptly. In Sweden they increased interest rates because they believed that there was a risk of inflation but today they have cut interest rates to a negative number.

Why did the market get it so wrong in predicting what the Fed might do? The reason that the market was discounting close to a zero probability of a rate rise by the Fed was that firstly the last set of minutes from the Fed seemed to suggest that an eminent rate rise by the Fed was still some months away; secondly economic data has in general continued to be mixed. The labour market data has shown more people in work and earning higher salaries and this appears to have led to a recent increase in retail sales growth. However, the manufacturing sector remains in the doldrums with industrial confidence appearing to weaken and inventories at very high levels relative to current levels of sales. Companies continue to show a great reluctance to invest in the future with capital investment weak, but retirement of capital through share buybacks back to previous peaks.

What impact will a Fed rate rise have on the financial markets? The initial reaction is for bonds and equities to sell off. They both steadied in the last hours of trading at the end of the week. To be honest the linkages between markets have become somewhat complex in the wake of the waves of quantitative easing, that the Fed can only be guessing at what impact a rate rise could have on the global economy and markets. All dollar-pegged currencies will see a likely rate rise to follow the Fed. However, for the vast majority of those countries particularly in the Middle East that is just not what the respective countries want at this juncture. Also the inevitable rise in the value of the dollar is another form of monetary tightening that the countries will likely have to absorb.

We continue to see the balance of risks as being weighted against equity markets. At the end of the day any rate rise by the Fed must have the aim of slowing the momentum of economic growth. However the Fed will be anxious to see that the rate rise does not lead to a serious setback in the momentum of the economy. Should the US economy weaken markedly, as a consequence of a rate rise, financial markets could be in serious trouble. If Fed policy is seen to have failed there could be a large fall in investor confidence leading to a sizeable fall in equity markets.

We do not see the risk of a marked sell off of bonds. For choice, investors are likely to fear the rate rise with a concern that it will slow global growth and erase any inflation risk. Hence, we expect bond markets to continue to offer a safe haven. Equally we do not expect the Fed to raise rates aggressively, hence we see limited risk of higher-risk bonds selling off markedly. Such an outcome would only happen if it was thought that Fed policy would significantly slow global growth.

Although on my current trip to Singapore I might feel I am thousands of miles away from the epicentre of the oil market, I'm told I'm in fact witnessing in real time one of the factors that should cap the current rise in oil prices. As you survey the scene out across the South China Sea, parked just off the coast of Singapore are large numbers of oil tankers holding part of the huge inventory of oil that overhangs the oil market. Freight data from Thomson Reuters Eikon shows that the tankers are filled with around 48 million barrels of oil. One of the reasons that oil inventories have risen is that the owners of the oil had been able to sell their cargos in the forward market for a premium to the current spot price. However forward prices have started to collapse back to the spot price. Many of the owners of the oil sitting in tankers on the high seas are struggling to afford the daily $40,000 cost of renting the VLCCs that store the oil. Hence financing to storage charters has jumped sharply in recent weeks. If the owners of the crude can no longer get funding or cannot afford the losses of the daily charting costs, the oil will come to the spot market and potentially push the oil price lower.

We continue to hold very tactically a positive view of Japanese equities. The market gained support last week as the dollar rallied. The market was also helped by much better than expected first quarter GDP data that showed 1.7% quarterly annualised growth in the Japanese economy. The market is hoping for more evidence of support from the policy makers in coming weeks. The Japanese government is expected to unveil a package of spending worth over 1% of GDP in the coming weeks. We expect this action to be reinforced by a further wave of easing by the Bank of Japan. We would target the Nikkei index to rally back to its recent highs of 17,500 from the current 16,738.

We recently urged some caution on Indian asset markets after disappointing inflation data that rather put the brake on further interest rate cuts. **Our caution is reinforced by** the political chatter that the current Governor of the central bank may not be reappointed when his term ends in September. The politicians in India would do well to understand how much credibility Raghuram Rajan has brought the country in global financial markets. Should he be ousted by political forces, this would not go down well in international markets. Whilst the politicians feel they may find a candidate who would cut interest rates faster than the pace set by the current governor, the cost would be of much higher long term interest rates that would only do damage to the economy.

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