So Many Questions

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

Gary Dugan
Chief Investment Officer

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.

---

Gary Dugan
Chief Investment Officer
garydugan@emiratesnbd.com
+971 (0)4 609 3739
Disclaimer

Reliance

Emirates NBD Bank PJSC (“Emirates NBD”) uses reasonable efforts to obtain information from sources which it believes to be reliable, however, Emirates NBD makes no representation that the information or opinions contained in this publication are accurate, reliable or complete and should not be relied on as such or acted upon without further verification. Opinions, estimates and expressions of judgment are those of the writer and are subject to change without notice. Emirates NBD accepts no responsibility whatsoever for any loss or damage caused by any act or omission taken as a result of the information contained in this publication. Data/information provided herein are intended to serve for illustrative purposes and are not designed to initiate or conclude any transaction. In addition this publication is prepared as of a particular date and time and will not reflect subsequent changes in the market or changes in any other factors relevant to the determination of whether a particular investment activity is advisable. This publication may include data/information taken from stock exchanges and other sources from around the world and Emirates NBD does not guarantee the sequence, accuracy, completeness, or timeliness provided thereto by unaffiliated third parties. Moreover, the provision of certain data/information in this publication is subject to the terms and conditions of other agreements to which Emirates NBD is a party. Anyone proposing to rely on or use the information contained in this publication should independently verify and check the accuracy, completeness, reliability and suitability of the information and should obtain independent and specific advice from appropriate professionals or experts. Further, references to any financial instrument or investment product are not intended to imply that an actual trading market exists for such instrument or product. The information and opinions contained in Emirates NBD publications are provided for personal use and informational purposes only and are subject to change without notice. The material and information found in this publication are for general circulation only and have not been prepared with any regard to the objectives, financial situation and particular needs of any specific person, wherever situated.

Confidentiality

This publication is provided to you upon request on a confidential basis for informational purposes only and is not intended for trading purposes or to be passed on or disclosed to any other person and/or to any jurisdiction that would render the distribution illegal. The investor may not offer any part of this publication for sale or distribute it over any medium including but not limited to over-the-air television or radio broadcast, a computer network or hyperlink framing on the internet without the prior written consent of Emirates NBD or construct a database of any kind.

Solicitation

None of the content in this publication constitutes a solicitation, offer, opinion, or recommendation by Emirates NBD to buy or sell any security, or to provide legal, tax, accounting, or investment advice or services regarding the profitability or suitability of any security or investment and further does not provide any fiduciary or financial advice.

Third party

The security or investment described in this publication may not be eligible for sale or subscription to certain categories of investors. This publication is not intended for use by, or distribution to, any person or entity in any jurisdiction or country where such use or distribution would be contrary to law or regulation. It is the responsibility of any person in possession of this publication to investigate and observe all applicable laws and regulations of the relevant jurisdiction. This publication may not be conveyed to or used by a third party without the express consent of Emirates NBD. The investor may not use the data in this publication in any way to improve the quality of any data sold or contributed to by the investor to any third party.

Liability

Anything to the contrary herein set forth notwithstanding, Emirates NBD, its suppliers, agents, directors, officers, employees, representatives, successors, assigns, affiliates or subsidiaries shall not, directly or indirectly, be liable, in any way, to you or any other person for any: (a) inaccuracies or errors in or omissions from the this publication including, but not limited to, quotes and financial data; or (b) loss or damage arising from the use of this publication, including, but not limited to any investment decision occasioned thereby. Under no circumstances, including but not limited to negligence, shall Emirates NBD, its suppliers, agents, directors, officers, employees, representatives, successors, assigns, affiliates or subsidiaries be liable to you for direct, indirect, incidental, consequential, special, punitive, or exemplary damages even if Emirates NBD has been advised specifically of the possibility of such damages,
arising from the use of this publication, including but not limited to, loss of revenue, opportunity, or anticipated profits or lost business.

This publication does not provide individually tailored investment advice and is prepared without regard to the individual financial circumstances and objectives of person who receive it. The appropriateness of an investment activity or strategy will depend on the person’s individual circumstances and objectives and these activities may not be suitable for all persons. In addition, before entering into any transaction, the risks should be fully understood and a determination made as to whether a transaction is appropriate given the person’s investment objectives, financial and operational resources, experiences and other relevant circumstances. The obligations relating to a particular transaction (and contractual relationship) including, without limitation, the nature and extent of their exposure to risk should be known as well as any regulatory requirements and restrictions applicable thereto.

Forward looking

Past performance is not necessarily a guide to future performance and should not be seen as an indication of future performance of any investment activity. The information contained in this publication does not purport to contain all matters relevant to any particular investment or financial instrument and all statements as to future matters are not guaranteed to be accurate. Certain matters in this publication about the future performance of Emirates NBD or members of its group (the Group), including without limitation, future revenues, earnings, strategies, prospects and all other statements that are not purely historical, constitute “forward-looking statements”. Such forward-looking statements are based on current expectations or beliefs, as well as assumptions about future events, made from information currently available. Forward-looking statements often use words such as “anticipate”, “target”, “expect”, “estimate”, “intend”, “plan”, “goal”, “seek”, “believe”, “will”, “may”, “should”, “would”, “could” or other words of similar meaning. Undue reliance should not be placed on any such statements in making an investment decision, as forward-looking statements, by their nature, are subject to known and unknown risks and uncertainties that could cause actual results, as well as the Group’s plans and objectives, to differ materially from those expressed or implied in the forward-looking statements. Estimates of future performance are based on assumptions that may not be realized

Risk

Data included in this publication may rely on models that do not reflect or take into account all potentially significant factors such as market risk, liquidity risk, and credit risk. Emirates NBD may use different models, make valuation adjustments, or use different methodologies when determining prices at which Emirates NBD is willing to trade financial instruments and/or when valuing its own inventory positions for its books and records.

The use of this publication is at the sole risk of the investor and this publication and anything contained herein, is provided "as is" and "as available." Emirates NBD makes no warranty of any kind, express or implied, as to this publication, including, but not limited to, merchantability, non-infringement, title, or fitness for a particular purpose or use.

Investment in financial instruments involves risks and returns may vary. The value of and income from your investments may vary because of changes in interest rates, foreign exchange rates, prices and other factors and there is the possibility that you may lose the principle amount invested. Before making an investment, investors should consult their advisers on the legal, regulatory, tax, business, investment, financial and accounting implications of the investment.

In receiving this publication, the investor acknowledges it is fully aware that there are risks associated with investment activities. Moreover, the responsibility to obtain and carefully read and understand the content of documents relating to any investment activity described in this publication and to seek separate, independent financial advice if required to assess whether a particular investment activity described herein is suitable, lies exclusively with the investor.

Intellectual property

This publication has been developed, compiled, prepared, revised, selected, and arranged by Emirates NBD and others (including certain other information sources) through the application of methods and standards of judgment developed and applied through the expenditure of substantial time, effort, and money and constitutes valuable intellectual property of Emirates NBD and such others.

All present and future rights in and to trade secrets, patents, copyrights, trademarks, service marks, know-how, and other proprietary rights of any type under the laws of any governmental authority, domestic or foreign, shall, as between the investor and Emirates NBD, at all times be and remain the sole and exclusive property of Emirates NBD and/or other lawful parties. Except as specifically permitted in writing, the investor may not copy or make any use of the content of this publication or any portion thereof. Except as specifically permitted in writing, the investor shall not use the intellectual property rights connected with this publication, or the
names of any individual participant in, or contributor to, the content of this publication, or any variations or derivatives thereof, for any purpose.

This publication is intended solely for non-commercial use and benefit, and not for resale or other transfer or disposition to, or use by or for the benefit of, any other person or entity. By accepting this publication, the investor agrees not to use, transfer, distribute, copy, reproduce, publish, display, modify, create, or dispose of any information contained in this publication in any manner that could compete with the business interests of Emirates NBD. Furthermore, the investor may not use any of the trademarks, trade names, service marks, copyrights, or logos of Emirates NBD or its subsidiaries in any manner which creates the impression that such items belong to or are associated with the investor or, except as otherwise provided with Emirates NBD, prior written consent. The investor has no ownership rights in and to any of such items.

Emirates NBD is licensed and regulated by the UAE Central Bank.

**United Kingdom**

This publication was prepared by Emirates NBD Bank PJSC in the United Arab Emirates. It has been issued and approved for distribution to clients by the London branch of Emirates NBD Bank PJSC which is authorized by the Prudential Regulation Authority and regulated by the Financial Conduct Authority (FCA) and the Prudential Regulation Authority in the UK. Some investments and services are not available to clients of the London Branch. Any services provided by Emirates NBD Bank PJSC outside the UK will not be regulated by the FCA and you will not receive all the protections afforded to retail customers under the FCA regime, such as the Financial Ombudsman Service and the Financial Services Compensation Scheme. Changes in foreign exchange rates may affect any of the returns or income set out within this publication.

**Singapore**

This publication was prepared by Emirates NBD Bank PJSC in the United Arab Emirates. It has been issued and approved for distribution to clients by the Singapore branch of Emirates NBD Bank PJSC which is licensed by the Monetary Authority of Singapore (MAS) and subject to applicable laws (including the Financial Advisers Act (FAA) and the Securities and Futures Act (SFA)). Any services provided by Emirates NBD Bank PJSC outside Singapore will not be regulated by the MAS or subject to the provisions of the FAA and/or SFA, and you will not receive all the protections afforded to retail customers under the FAA and/or SFA. Changes in foreign exchange rates may affect any of the returns or income set out within this publication.

Please contact your Relationship Manager for further details or for clarification of the contents, where appropriate.

For contact information, please visit [www.emiratesnbd.com](http://www.emiratesnbd.com)