Emirates NBD

Interest Rates
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Synchronised Interest Rate Cuts

The first US rate cut in a decade

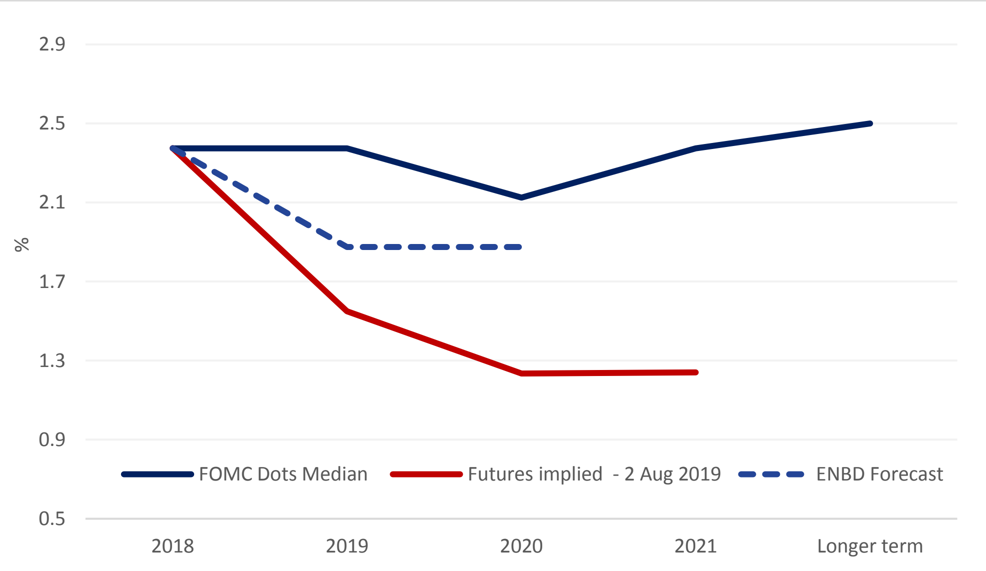
In a much anticipated move, the US Federal Reserve cut the target interest rate by 25bps to be between the 2.00% - 2.25% range, citing potential negative implications of global developments for the US economic outlook as well as muted inflation pressure in the country as the reasons to lower rates. The IOER (interest on excess reserve) rate was also reduced by 25bps to 2.10%.

The Fed also opted to end its balance sheet runoff effective beginning of August, rather than the end of September this year as originally planned. Until now the Fed was normalizing the balance sheet at the rate of USD15bn/month with the intention of keeping the size of the balance sheet constant from September. We think this move will have only a marginal impact on markets.

Will the Fed cut rates again in September?

The Fed is citing this cut as an insurance against recession and a mid-cycle adjustment to ensure continued expansion, however, pricing action in the markets reflect that investors don't really believe that the insurance cut will work, particularly given the lack of progress in the US-China trade negotiations. While the Fed's dot plot remained unchanged, Fed fund futures implied probability of rate cut in September now stands at over 90% for 25bps and 10% for a 50bp cut.

Rate cuts – dot plot vs mkt expectations



Source: Bloomberg, Emirates NBD Research

Federal Reserve officials seem to be looking at history for prior examples of "mid-cycle adjustments" tacitly signaling their view that the current environment may be similar to the 1995 and 1998 episodes, when the Fed cut rates 75bps each time. However, we think the current situation, whereby global economic growth is under threat from trade wars and negative rates are prevailing in most of the developed world, the current cycle is unlikely to behave like the ones that occurred two decades ago.

Though economic growth in the US remains in very healthy territory, residential investment – the most interest rate sensitive component of GDP – has been falling for few quarters now. This coupled with weaker trend in manufacturing and slowing job growth indicates increasing possibility of GDP growth slowing substantially and therefore the chances of the Fed's so called mid-cycle adjustment morphing into a full-blown cutting cycle are reasonably high.

Is the yield curve flattening auguring an impending recession?

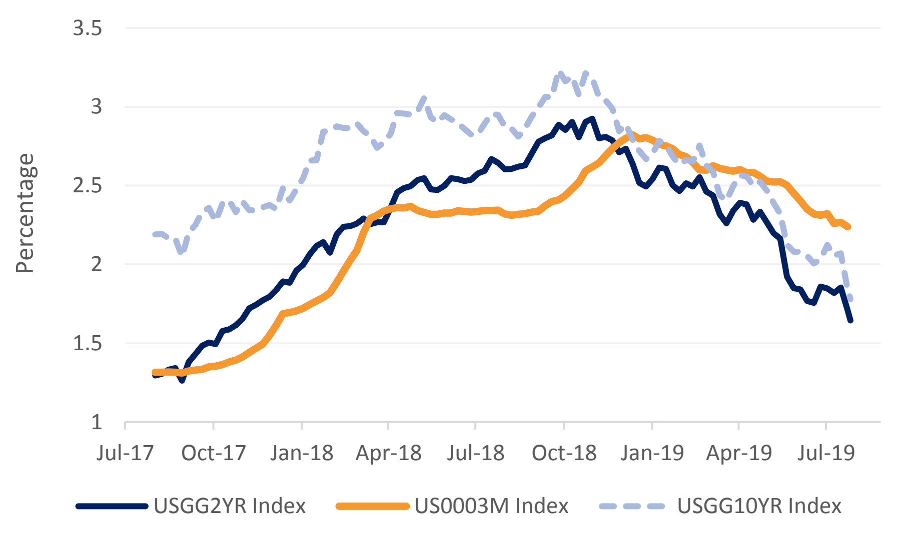
The sudden collapse of the US-China trade talks and the threat of the US imposing 10% tariff on USD 300 billion of Chinese goods weighed heavily on investor sentiment last week. The safe haven bid on the back of rising uncertainty pushed government bonds in the developed world higher. Yields on 2yr, 5yr, 10yr and 30yr USTs closed the month significantly lower at 1.64% (-22bps, m/m), 1.58% (-25bps), 1.77% (-26bps) and 2.31% (-23bps, m/m) respectively.

Despite the Fed's message that this rate cut was only a mid- cycle adjustment, the UST yield curve flattened with 2yr-5yr spread getting deeper in the negative territory at -6bps and the 2yr-10yr spread narrowing 7bps to 13bps now.

Most recessions are proceeded by flattening or inverted yield curves, however, all yield curve flattening periods are not followed by a recession. Beside economic growth and the Fed's policy bias, there are several other factors that can influence the shape of the US yield curve (demand/ supply dynamics, safe haven bid, push/pull from lower yields on other risk-free assets etc.)

The US economy remains strong on most measures and we don't foresee risk of recession any time soon. We think the current decline in long term UST yields is, to some extent, due to its appeal as a high yielding security.

Inverted 3m-10yr curve



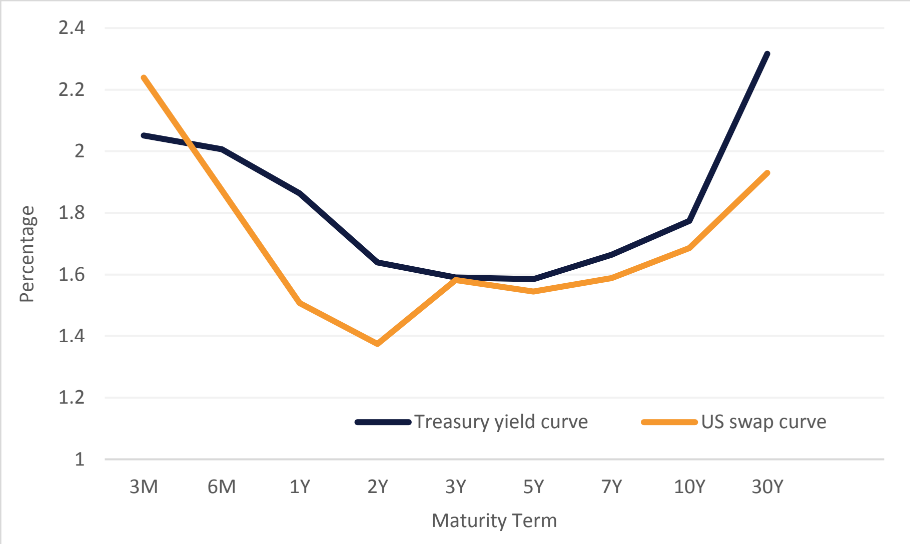
Source: Bloomberg, Emirates NBD Research

Negative swap curve could prevail for some time

The US swap spreads over treasuries are negative for tenures all the way up to 30 years. We think the spreads may not become positive for some time even if yields keeping coming down as lower yields will likely increase demand for longer-duration instruments by asset managers (in order to get higher return) which will help bring longer-duration swap spreads to decline at a similar pace or higher.

Historically the swap spreads had to account for credit risk of the banks and therefore tended to remain higher than the underlying risk-free treasury yields. However, central clearing of swaps has nullified this risk, causing swap spreads to largely reflect the demand/supply dynamics in this market.

Negative swap spreads over treasury likely to prevail



Source: Bloomberg, Emirates NBD Research

GCC Policy Rates

As expected, several GCC central banks cut interest rates by 25bps in sync with the Fed rate cut and consistent with the management of their currency pegs.

Saudi Arabian Monetary Authority, the KSA's central bank decided to lower Repo rate to 2.75% from 3% and Reverse repo rate to 2.25% from 2.50%. The policy rate adjustment is seen to be in line with SAMA's objective of preserving monetary stability.

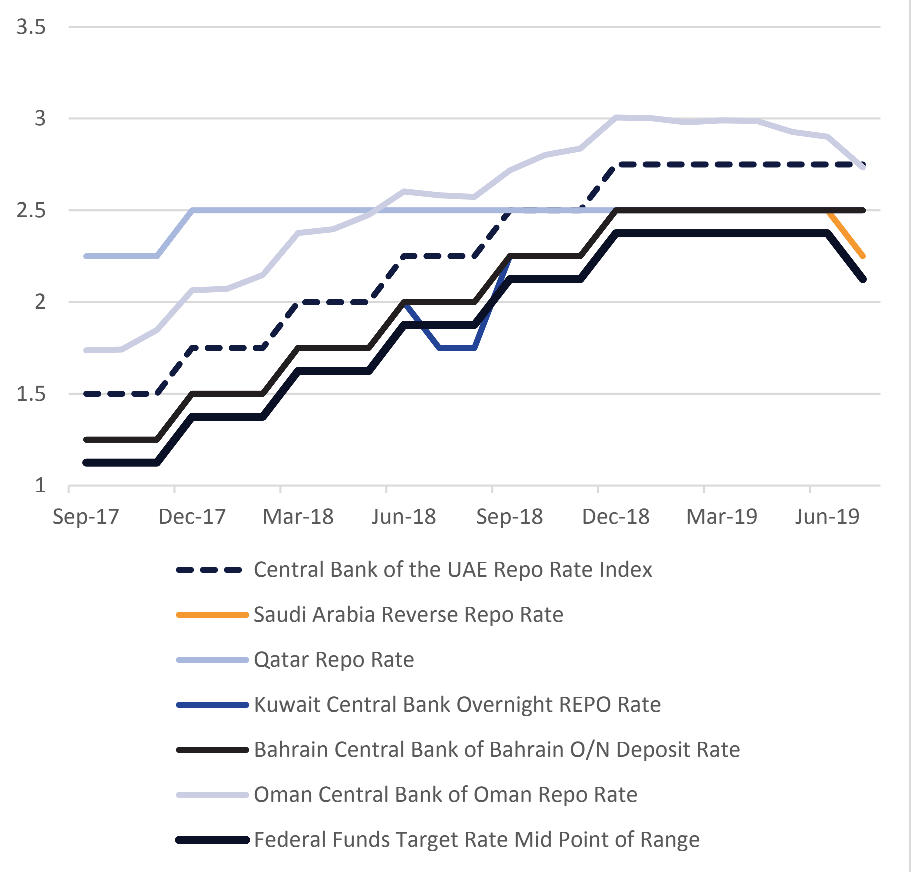
Central Bank of Bahrain also cut its key policy rates by 25bps taking the overnight deposit rate to 2.25%, 1 week deposit rate to 2.50% and overnight repo rate to 4.25%.

In line with historical practice, the Central Bank of the UAE maintained the gap of 50bps between its borrowing and lending rate as it reduced the 1 week deposit rate and Repo rate by 25 bps each to 2.00% and 2.50% respectively. The Islamic repo rate was also cut 25bps to 2.50%.

Central Bank of Oman traditionally keeps its policy rate setting slightly flexible. Instead of a set rate, the repo rate fluctuates on a daily basis within a tight range. It has now fallen to 2.74% vs 2.90% a month ago.

Instead of dollar, the Kuwaiti dinar is pegged to a basket of currencies though the basket remains heavily weighted in favour of the USD. Kuwait Central bank raised its key discount rate four times since mid-2015 by 25bps each instead of the nine rate hikes that the Federal reserve had. The current discount rate at 3% and repo rate at 2.5% will not be cut in sync with Fed rate cut last month.

GCC policy rates cut in sync with the Fed

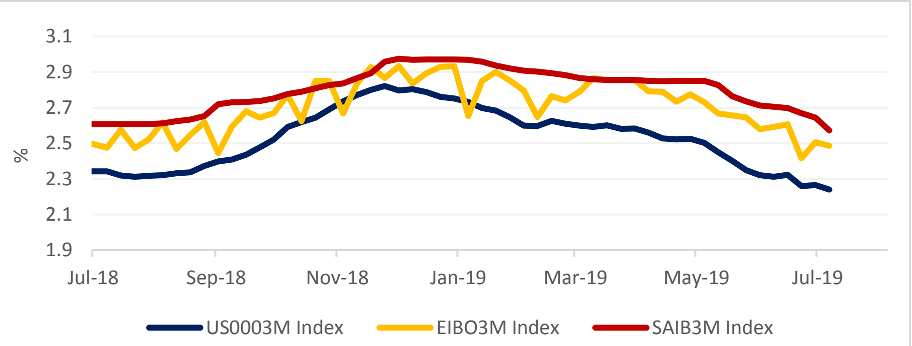


Source: Bloomberg, Emirates NBD Research

GCC Interbank Rates

Interbank rates in the GCC moved in tandem with their pegged counterparts. Liquidity in the banking sector has been abundant as loan growth remained muted in the face of slow economic growth. The cut in policy rates is expected to boost activity and growth in the non-oil sector thereby driving demand for credit which could see some widening in SAIBOR and EIBOR's spread over LIBOR.

GCC local rates cut in sync with the Fed



Source: Bloomberg, Emirates NBD Research

Interest Rate Forecasts

US Treasuries Forecasts					Forwards		
	Current	**3M**	**6M**	**12M**	**3M**	**6M**	**12M**
2y	1.64	1.75	1.80	1.90			
10y	1.78	1.90	2.00	2.00			
2s10s (bp)	14	15	20	10			
3M Libor					**3M Libor**		
3m	2.24	2.00	2.00	1.75			
3M Eibor					**3M Eibor**		
3m	2.49	2.25	2.25	2.00			
Policy Rate Forecasts							
	Current %	**3M**	**6M**	**12M**			
FED (Upper Band)	2.25	2.00	2.00	1.75			
ECB (deposit rate)	-0.40	-0.50	-0.50	-0.50			
BoE	0.75	0.75	0.50	0.50			
BoJ	-0.10	-0.10	-0.10	-0.10			
SNB	-0.75	-0.75	-0.75	-0.75			
RBA	1.00	1.00	0.75	0.75			
RBI (repo)	5.75	5.50	5.50	5.25			
SAMA (reverse repo)	2.25	2.00	2.00	1.75			
UAE (Repo rate)	2.50	2.25	2.25	2.00			
CBK (o/n repo rate)	2.50	2.50	2.50	2.50			
QCB (repo rate)	2.50	2.50	2.50	2.50			
CBB (o/n depo)	2.25	2.00	2.00	1.75			
CBO (o/n repo)	2.77	2.52	2.52	2.25			
CBE (o/n depo)	15.75	13.75	13.75	13.75			

Source: Bloomberg, Emirates NBD Research

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