بنك الإمارات دبي الوطني
Emirates NBD

Interest Rates
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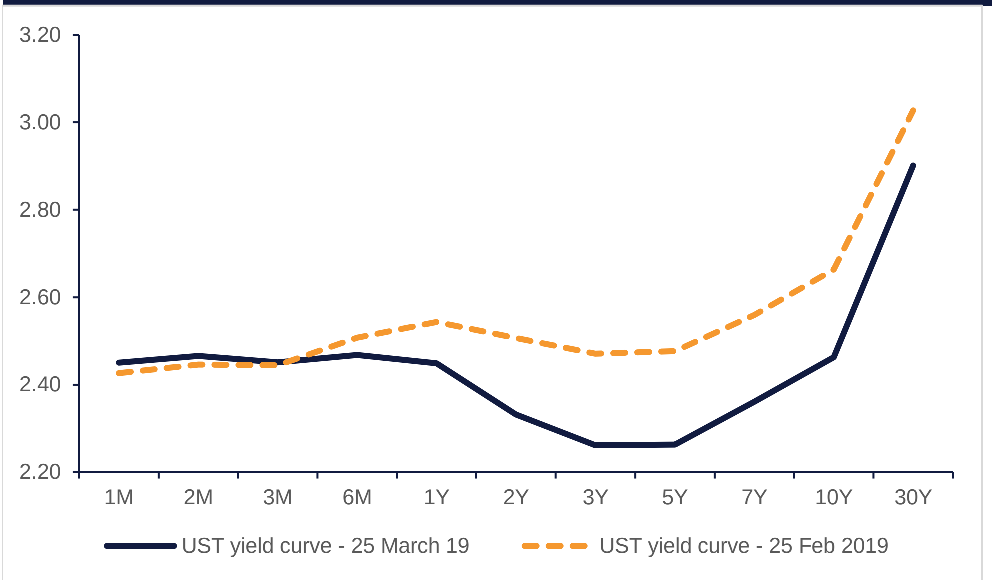
March FOMC in focus

US Treasuries surged on heavy volumes last week with yields dropping by 10-15bps across the curve. Following the unexpectedly dovish statement and the revised dot plot released after the conclusion of last week's FOMC meeting, yield on 10yr USTs dropped 15bps to 2.43% - its biggest weekly drop since mid-2016. USD swap spreads tightened into Treasuries rally, with 10- and 30-year reaching multi-month lows. The extreme dovish shift in the front-end left the OIS pricing in 20bps of cut for this year and another 30bbp cuts by 4Q 2020. The 2yr5yr curve that had spent most of this year in flat to slightly negative territory has now become decidedly inverted. Against this backdrop we take a closer look at the path of interest rates going forward.

US Treasury Yield Curve %



Source: Bloomberg, Emirates NBD Research

Fed watch

As expected, the FOMC left rates unchanged at its meeting last week and revised its growth forecasts down for this year and next. The 'dot plot', shows the median expectation is now for no rate increases in 2019, compared with expectations for two hikes as of last December. This revised path reflects the 'patient' stance adopted at the January FOMC and reiterate the Fed's data-dependent reactive rather than proactive stance.

There is a forecast of one rate hike in 2020 that we think will not happen given that the bar for further tightening is clearly high and unlikely to be met. We do not see any catalyst that could either provide a strong boost to economic growth or a substantial pick-up in inflation from the current levels.

Though he Fed took note of slower household and business spending, it left inflation expectation unchanged at around the target rate of 2%. Even with less restrictive monetary policy and easier financial conditions, Fed officials still expect growth will decelerate. The median forecast for Q4/Q4 GDP growth in 2019 reduced to 2.1%, from 2.3% while the 2020 forecast was cut to 1.9%, from 2.0%. These projections imply that, following a sharp slowdown in the first quarter, the Fed expects economic growth to reaccelerate over the rest of the year thereby keeping inflation anchored at 2%.

Inflation in the US currently appears range-bound between 1.8% - 2.2%. At around 3.4%, wage growth is consistent with a sustainable 2% pace of inflation but does not point to an imminent acceleration of price pressures. Additional firming of labour inflation is probably needed for a pickup in services inflation to offset strong dollar-driven weakness in goods prices. **While we expect core inflation to sustain or show a marginal pick up, we think it will not necessarily reach a level required to warrant further rate hikes.**

FOMC Forecasts

	2016	2017	2018	2019	2020
Real GDP (YoY %)	1.60	2.20	2.90	2.10	1.90
Core PCE (YoY %)	1.27	2.12	2.45	1.80	2.00
Unemployment (%)	4.88	4.35	3.89	3.70	3.80

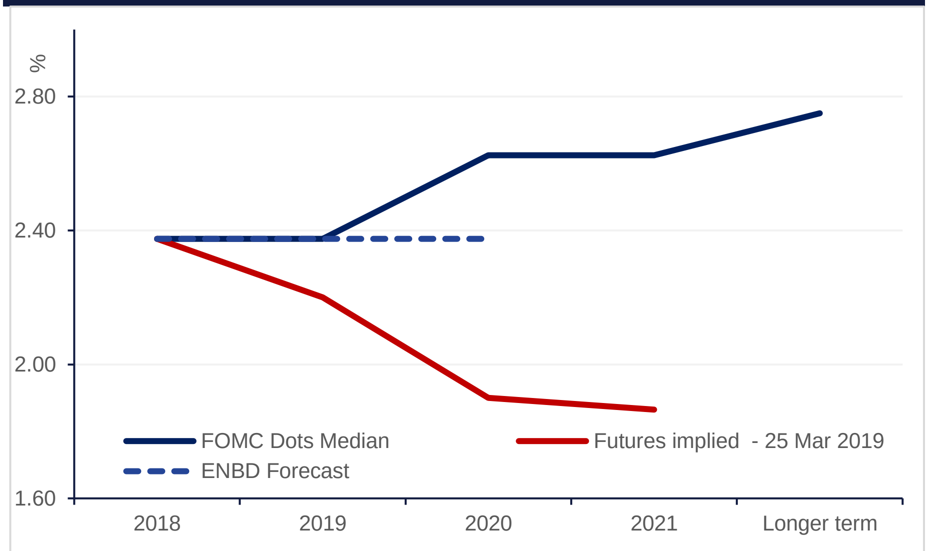
Source: Bloomberg, Emirates NBD Research

America's unemployment rate has fallen to less than 4% from 10% in 2009 and inflation has still not picked up pace. The trends suggest that the jobless rate may be losing some of its reliability as a policy guide. Against that backdrop, Fed officials have revised their estimates for the unemployment level they believe would be consistent with stable inflation in the long run down to 4.3% -- a big change from 2010, when they believed that number was above 5%. They see the jobless rate bottoming out at 3.7% this year, before creeping higher.

UNCERTAIN NEUTRAL RATE

The Fed has no conviction of what the long term neutral rate should be. When they began hiking in December 2015, they believed that number was around 3.5%. Now they think it's more like 2.75% though the new dot plot projections show that even reaching that level will be difficult given the recent slow-down in economic growth.

The Fed dots vs markets



Source: Bloomberg, Emirates NBD Research

As of now, the market is pricing in a 50% chance of a cut by the end of 2019 and 1.3 cuts by the end of 2020. In contrast, **we see little justification for any rate cut this year amid above trend economic growth, four decade low unemployment level and core inflation close to the Fed's target of 2%.**

FED BALANCE SHEET TAPERING

The Fed also announced plans to end balance sheet normalization in September this year, and, will cut the pace of its monthly redemptions in half beginning in May. The Fed's $4.3trn balance sheet has already shrunk to $3.8trn and should be close to $3.5trn by September under the revised plan which will be much higher than its pre-crisis level of $0.9 trillion. Details on the longer-run framework are still to come.

We take note of the Fed Chairman Jerome Powell's comment that he does not view the balance-sheet unwind as a form of monetary-policy tightening. We think the central bank intended to send a dovish signal by ending the unwind earlier than it previously suggested.

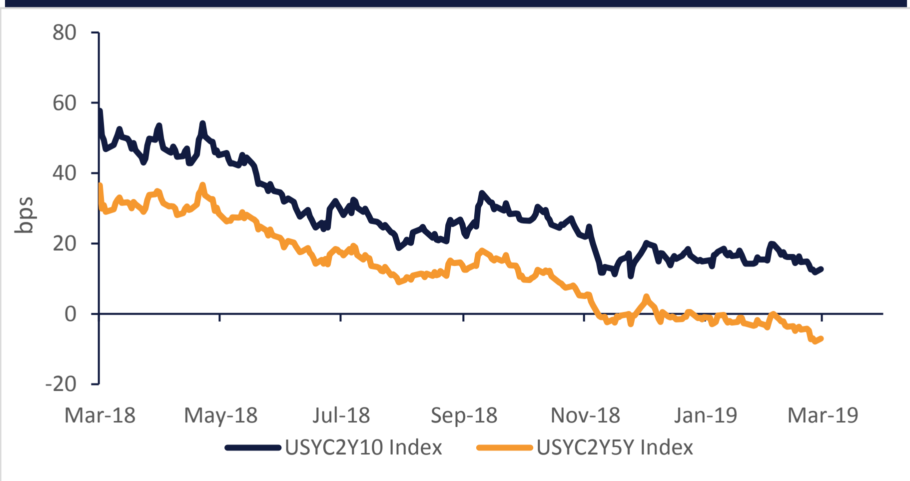
CHANGING PERSONALITIES AT THE FED

We also take note of the changing personalities on the Federal Reserve board. Recently nominated to the Federal Reserve board, Stephen Moore called the Fed's December interest-rate hike "a very substantial mistake" while adding that he looks forward to working with Chairman Jerome Powell to help ensure the U.S. economy continues to expand. **Though his nomination is subject to confirmation by the US Senate, if appointed, he is likely to tilt the FOMC's bias towards further dovishness.** That said, we note that two previous Trump nominees, Nellie Liang and Marvin Goodfriend, failed to advance in the Senate in 2018.

YIELD CURVE INVERSION

The UST yield curve, particularly the 2s-10s spread, after having flattened to 20bps from 60 bps in early 2018, has further reduced to 16bps as we go to print. The recent flatness of the yield curve has raised concerns about an ultimate yield curve inversion. **No consensus exists on the FOMC as to how to incorporate the yield curve dynamics into policy decisions.** The predominant thought seems to be that "this time it is different'.

UST curves – 2y20y and 2y5y



Source: Bloomberg

While yield curve inversion has traditionally been a good indicator of recessions, we think the current level of interest rates remain very accommodative despite three years of rate increases. Recessions are more likely when real interest rates exceed GDP growth. The inflation-adjusted fed funds rate has barely moved into positive territory (just 0.4%), let alone the type of level which would prove restrictive to growth. There is no historical evidence of a recession occurring with real rates so low.

We have a relatively neutral view on the UST yields going forward. It will take few more months of data to make a bullish or bearish case. As such t**he 10yr UST yield is likely to fluctuate between 2.40% and 2.80%for most of this year with a bias towards the lower end of this range in the next few months**.

Interest Rate Forecasts

USD Swaps Forecasts					Forwards		
	Current	3M	6M	12M	3M	6M	12M
2y	2.38	2.50	2.50	2.50			
10y	2.41	2.55	2.55	2.55			
2s10s (bp)	3	5	5	5			
US Treasuries Forecasts					US Treasuries Forecasts		
2y	2.24	2.40	2.40	2.40			
10y	2.40	2.55	2.55	2.55			
2s10s (bp)	16	15	15	15			
3M Libor					3M Libor		
3m	2.61	2.70	2.70	2.70			
3M Eibor					3M Eibor		
3m	2.75	2.85	2.85	2.85			
Policy Rate Forecasts							
	Current %	3M	6M	12M			
FED (Upper Band)	2.50	2.50	2.50	2.50			
ECB	0.00	0.00	0.00	0.00			
BoE	0.75	0.75	0.75	0.75			
BoJ	-0.10	-0.10	-0.10	-0.10			
SNB	-0.75	-0.75	-0.75	-0.75			
RBA	1.50	1.50	1.50	1.50			
RBI (repo)	6.25	6.00	6.00	6.00			
SAMA (reverse repo)	2.50	2.50	2.50	2.50			
UAE (1W repo)	2.75	2.75	2.75	2.75			
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)	2.50	2.50	2.50	2.50			
CBO (o/n repo)	3.00	3.00	3.00	3.00			
CBE (o/n depo)	16.75	15.75	15.75	14.75			

Source: Bloomberg, Emirates NBD Research

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