RICHES FLORES RESEARCH

GLOBAL MACRO & THEMATIC INDEPENDENT RESEARCH

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GLOBAL MACRO

The Fed's big bet

With thirteen of its sixteen members believing that monetary tightening would be appropriate starting in 2015 and ten of those believing that the level of the Fed Funds will be greater or equal to 1% at the end of next year, the message delivered by the Fed following its meeting on March 18th and 19th breaks with its past communication. . Standing in stark contrast with the bond market's current anticipations, this shift is liable to trigger sharp reactions, which is troubling for a variety of reasons:
- for the capital markets, first, the distinct possibility that interest rates and the equity markets in the US and elsewhere in the world will overreact to this shift in tone;
- for the US economy, second, whose robustness is unclear and ability to deal with more expensive credit even more uncertain;
- and for emerging markets and the countries of southern Europe, lastly, who are exposed to the increasing risk of capital flight.

We continue to believe that the Fed is on the wrong path. Accelerating the end of QE and an interest rate hike on a 2015 horizon hardly seem to be in tune with the reality of the economic situation in the US or the rest of the world. We are maintaining our forecast of a backlash before the summer and a fall in long-term interest rates after probably increasing temporarily.

An extra step towards tightening

As the market was clearly expecting, the Fed removed the 6.5% unemployment rate from its criteria for determining when the American economy might be able to handle a rate hike. The move gives the central bank greater leeway, it also cuts short questions arising from the publication of the minutes from January's meeting during which the possibility of a rate hike was discussed for the middle part of this year; only one of its members currently feels that this will play out.
However, the good news stops there.

The other messages delivered by the Fed via its press release and, in addition, the publication of its macro-economic forecasts and FOMC members' expectations on the key rate, are in fact much less encouraging and much more hawkish than before.

1- The Fed is continuing to reduce its asset purchases by $10bn, down to $55bn from $85bn as recently as December 2013.
2- It revised its growth forecast for 2014, 2015 and 2016 slightly downwards by lopping two-tenths off the top-end of its GDP to: 2.8%-3.0% for 2014, 3.0%-3.2% for 2015 and 2.5%-3.0% for 2016.
3- It is, however, revising its unemployment outlook down, by three-tenths this year and two-tenths for each of the two years thereafter, which stands in contrast to its GDP growth trajectory…an awkward situation indeed.
4- Lastly, the door to possible monetary tightening starting in 2015 has been opened now that we know that ten of its sixteen members expect the Fed Funds to be above or equal 1% by the end of 2015 and 12 expect rates in excess of 2% before end-2016.

Fed's Macro Economic Scenario as of March 19, 2014

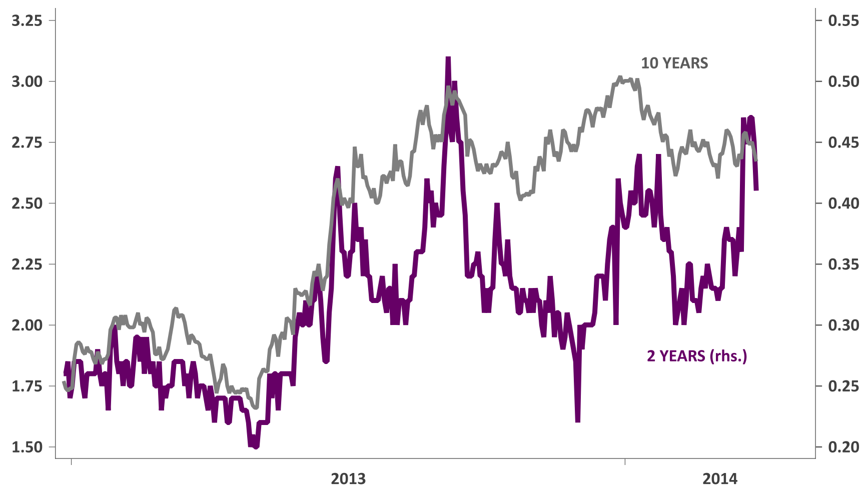
Variables	2014	2015	2016	Long term
Real GDP, %	**2.8 - 3.0**	**3.0 - 3.2**	**2.5 - 3.0**	**2.2 - 2.3**
December Forecasts	*2.8 - 3.2*	*3.0 - 3.4*	*2.5 - 3.2*	*2.2 - 2.4*
Unemployment rate	**6.1 - 6.3**	**5.6 - 5.9**	**5.2 - 5.6**	**5.2 - 5.6**
December Forecasts	*6.3 - 6.6*	*5.8 - 6.1*	*5.3 - 5.8*	*5.2 - 5.8*
Inflation	**1.5 - 1.6**	**1.5 - 2.0**	**1.7 - 2.0**	**2.0**
December Forecasts	*1.4 - 1.6*	*1.5 - 2.0*	*1.7 - 2.0*	*2.0*

Source: US Federal Reserve Board

Even though its statement reiterates that a significant period of time will separate the end of quantitative easing and the start of rate hikes, the aforementioned forecasts automatically puts the Fed in a position to break with its stance of the past few months. In fact, the tone seems to have been plainly expressed and a timetable for rate hikes already set. This triggered a radical shift in market anticipations that the Fed's recent communication had successfully avoided.

At 0.35% in recent days, the yield on 2-year treasuries clearly did not reflect the scenario expressed by the members of the Fed. The subsequent reaction was swift: in the minutes following the end of the FOMC meeting, 2Y bonds erased all of their YTD gains, a trend poised to continue and could quickly send 2Y yields to levels last seen in early September 2013, i.e. more than 0.50%.

US T-Bonds



Sources: RichesFlores Research, Macrobond

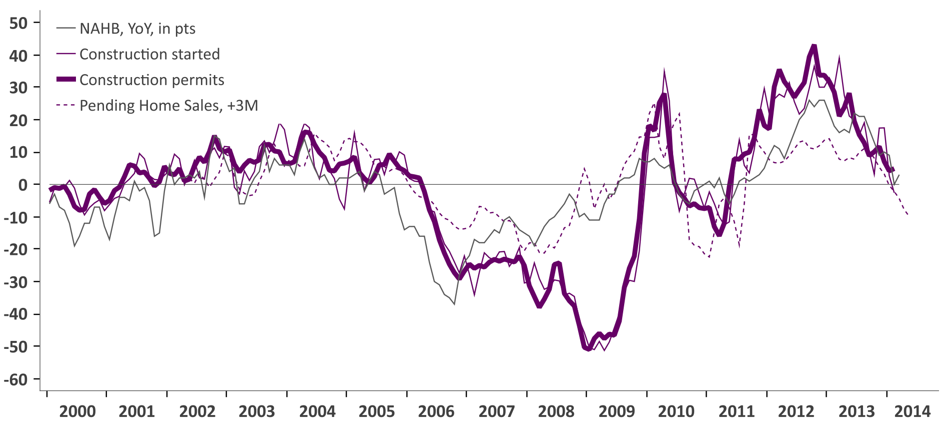
Another step closer to the danger zone

Such prospects are not a welcome sight and raise questions on future economic and financial developments.

The US economy has displayed multiple symptoms of weakness recently, suggesting its ability to handle higher interest rates could be more limited than what is generally thought. This is what the real estate market downturn in recent months has pointed to, particularly since mortgage rates began to move higher last spring.

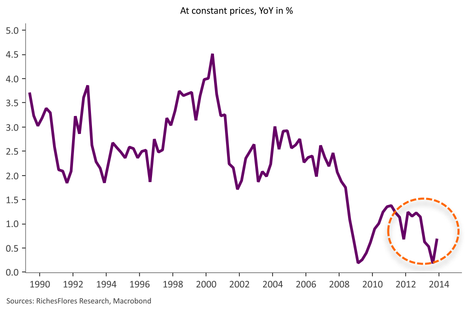
Real Estate Indicators

YoY, in %

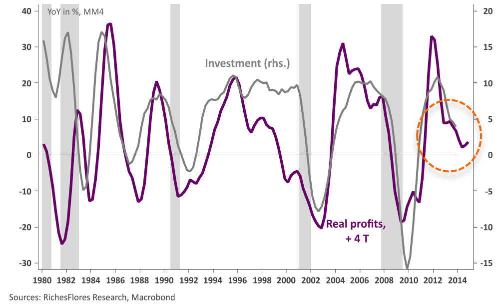


Sources: RichesFlores Research, Macrobond

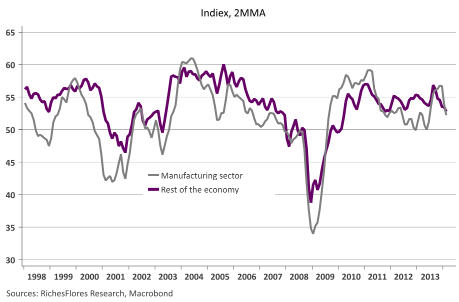
Stagnant service activity, disappointment on the business investment front, low business sentiment levels for SMEs and the inability of ISMs to stay above 55 sustainably are all worrying signs on the solidity of the growth improvement in H2 2013. They are also liable to be a reflection of the US economy's increasing vulnerability; although this is obviously not the Fed's take on the situation.



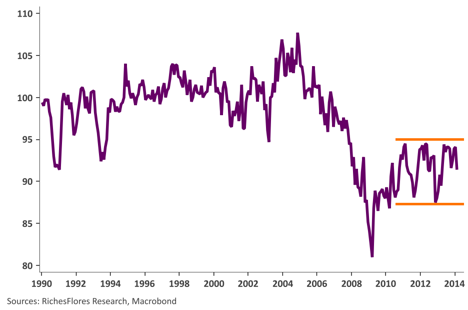
GDP Growth in Services (61 % of The Total Economy)



Growth in Real Profits and Investment of The Non-Financial Corporates



ISM Index: Manufacturing and Non-Manufacturing



NFIB Index Business Climat in SME

It is interesting to note that the bond markets have hardly "bought" the Fed's optimistic forecasts as of yet, as reflected by the lack of an increase in long-term interest rates in recent months. Will this change in the next few months? This will largely depend on data this spring…and it is feared such data will not be as good as expected. If this were to be case, a flattening of the yield curve would probably be expected in response to the "forced" increase in 2Y yields, which would be a portent of bad things to come.

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