# MARKET ANALYSIS

Ad-hoc research into market moving events from our in-house analysts



## FEDERAL RESERVE (FED)

- While most of Fed Chair Janet Yellen's dual testimonies to the House and Senate generally toed the line, her comments hinted at downside risks to the Fed's projection of the longer-term federal funds rate (currently between 2.80% and 3.00%, and will be updated next at its September meeting).

- "The neutral level of the federal funds rate is likely to remain close to zero in real terms over the medium term. If that is the case, we would not have much more additional work to do on moving to a neutral stance," the Fed chair said, seemingly hinting that the long-term Fed Funds Rate projection is lower than the current estimate of between 2.80% to 3.00%. The comments echoed those of Fed Governor Lael Brainard, suggesting that this might be a developing consensus on the Board of Governors.

- Some argued Yellen's comments alluded to real rates near zero. Rabobank, for instance, asked: "What does that mean, exactly - another three hikes over 2017-18? If so, and presuming that Yellen is also right that US inflation is going to go down near-term but this will be 'transitory,' and followed by a return to 2%, then she is implying a neutral Fed Funds rate is a zero real Fed Funds rate (2% rates, 2% CPI)." In Yellen's defence, she also noted that "the factors that are currently holding down the neutral rate will diminish somewhat over time, additional gradual rate hikes are likely to be appropriate over the next few years," though the market looked-through that part of her testimony.

- The probability of a third 2017 hike slipped on Friday following weak CPI data for June, though at just under 50%, comfortably remains in the range it has lingered in as of late. Fedspeak will be eyed to see whether officials still characterise the weakness as 'transitory', but that chatter isn't likely to come till after the policy meeting on 26 July, given the Fed now enters the blackout period (15-27 July). At her testimonies this week, Chair Yellen said the Fed would be watching incoming data, though she argued that it was temporary factors constraining inflation, and these factors were expected to pass.

- Despite the odds of a hike lengthening a touch, Pantheon Macroeconomics' analysts note that "both the July and August CPI reports will be released before the Fed meeting in September, and we think the odds are better than even that the core reverts to 0.2% M/M in both months; if that happens, and payrolls are as strong as we expect, the Fed's hawks will want to hike." Other analysts, like Barclays, make the case that the Fed will still begin trimming the balance sheet in September, though they are more uncertain of a December hike after the inflation data.

## EUROPEAN CENTRAL BANK (ECB)

- Following ECB President Mario Draghi's hawkish comments at the Sintra Monetary Policy Conference in June, markets are expecting an announcement that the central bank will further tighten policy soon, and begin to dial-back its asset purchase programme. The key question is whether it chooses to launch a tapering programme, or whether it will announce a once-off reduction. And we aren't likely to get any definitive answer to the question at next week's policy meeting, if the latest round of sources stories are to be believed; these sources have reportedly pointed to the September or October meeting as a likely time we'll get an update.

- The consensus view has the ECB standing pat on policy at the conclusion of its meeting on 20 July. "We expect next week's ECB meeting to be a double-balancing act for Mario Draghi and his colleagues," write analysts at ING. "On the one hand, the ECB wants to prepare financial markets for tapering, without creating a 'taper tantrum'. On the other hand, in a world without inflationary pressure, the ECB will have to substantiate the tapering preparation with economic arguments that do not leave market participants completely stumped; a balancing act that requires all of Draghi's verbal acrobatic skills."

- Draghi will likely be quizzed on the comments he made at Sintra, where he declared 'all signs now point to a strengthening and broadening recovery in the Eurozone, and deflationary forces have been replaced by inflationary ones', he reiterated that 'any policy shift would be gradual, and a considerable amount of accommodation was still required for inflation dynamics to become self-sustaining' (paraphrased).

- Taking Draghi's comments at face-value, the constructive tone from ECB policymakers has shifted over the last month, but analysts are yet to be convinced. Commerzbank, for instance, believe that Draghi and the ECB are employing a "taper bluff" that sells tapering as a sign of strength, rather than a function of the legal constraints that will be imposed on the central bank within the next year. Recall, the European Court of Justice ruled that the ECB's Outright Monetary Transactions are justified so long as the central bank doesn't become the dominant creditor of governments (judged to be one-third of an issuer's outstanding bonds).

## BANK OF JAPAN (BOJ)

- The BOJ is expected to keep its policy rate unchanged at -10bps this week, while continuing to target 10-year JGB yields at 0%. It will likely maintain language that it will keep buying approximately JPY 80tln of annual sovereign bonds annually;



However, “the language no longer means anything as the quantity of money has already become an endogenous variable rather than a policy variable,” write analysts at Credit Agricole.

- The BOJ will also release its economic outlook report, and Nikkei have suggested that it will raise its growth forecasts for the current fiscal year and next year by between 0.1 and 0.2ppts (in April, it had forecast growth of 1.6% for the current fiscal year) on the back of improving personal consumption, as well as on the back of increases in public and capital investment. The inflation profile, however, is expected to be revised down for both 2017 and 2018, though Nikkei reported that BOJ officials believe “the inflation trend in still intact”. Credit Agricole believes “such downward revisions to the Bank’s CPI forecasts will not trigger any policy given that they are almost conventional by now.”

- However, Credit Agricole argues that, more telling, will be the Bank’s communication: “it is the way the BoJ communicates that matters more than its policies and the issue lies in its forward guidance,” CA says, pointing out that the BOJ bases its forward guidance on the “inflation-overshooting commitment”, but “it has not served well as such with the commitment not showing any policy instruments (IOER or 10Y JGB yield).”

- The BOJ will also be quizzed about its market operations, after last week offering to buy unlimited quantities of 10yr JGBs when yields were at 0.11%, in an attempt to push the yield back towards zero. There is a theory that the central bank has a tolerance range between -0.10% and +0.10%, though it is unlikely to confirm this.

- The BOJ is also likely to get questions about the slower pace of JGB purchases. There is a debate emerging whether the yield curve targeting is a more effective policy tool rather than a fixed, nominal purchase target. Pantheon Macroeconomics’ analysts note that the scarce supply of bonds meant that large insurers and banks were reluctant to sell to the BOJ as part of their market operations, and the BOJ feared it would run out of JGBs at some point, which would make it impossible to meet its buying targets. “Yield curve targeting was one of the few options left open to the BoJ,” Pantheon says, “it was a smart move by that stage as it allowed the central bank to reduce its purchases in response to the tightening supply, thus keeping yields unchanged.”

**BANK OF CANADA (BOC)**

- While analysts were split over whether the BOC would raise rates, the market had greater conviction, and was ultimately vindicated after the central bank lifted rates by 25bps to 0.75%. The next debate, therefore, is when a subsequent hike will likely come – which would then fully unwind the two ‘emergency’ rate cuts made in 2015 – and what the policy stance will be following that. The tone of the press conference that followed with Governor Stephen Poloz and Carolyn Wilkins was distinctly hawkish, noting that the recovery was “broadening” and “becoming more sustainable”. Additionally, the updated Monetary Policy Report forecast suggested that the output gap would close at the end of this year, rather than the first half of 2018, as forecast in the previous MPR.

- Analysts, therefore, are preparing for the possibility of another hike at the September or even October meeting. Much will depend on the tone of data after Poloz did suggested that it would “be guided by incoming data as they inform the Bank’s inflation outlook”. Analysts at Scotiabank point out that the bank will be in a strong position to judge the evolution of the inflation profile in September, given there are two inflation releases on the docket between now and then. However, Scotia doesn’t see core inflation meaningfully jumping by then, and accordingly don’t expect another hike to follow at the September meeting.

- Scotiabank sees October as the most likely meeting for the next hike, given that, by then, the BOC will have observed an additional four inflation prints. “That should materially inform expectations for a bottoming of inflation with signs of transitioning higher,” Scotia writes, and “that should raise conviction toward expecting higher inflation in the relatively near-term.” Additionally, Scotiabank refers to commentary by the BOC in 2015, where it stated that policy adjustments don’t have to occur in a straight line, and as a result, the bank believes that bias may be symmetrical on the way out.

**BANK OF ENGLAND (BOE)**

- With current market pricing implying that the probability that the BOE will hike rates by year-end are pretty much a coinflip, BOE Deputy Governor Ben Broadbent pushed back against the hawks on the MPC, and sided with Governor Mark Carney by arguing that he was “not ready” to vote for rate rises given the “imponderables” that still exist.

- One of those imponderables is wage growth, and data released this week indicated that the real squeeze on incomes continues as wage inflation fell to a near three-year low, despite the jobless rate being at a four-decade low. “At present, unemployment is broadly in line with the BoE’s estimate of the equilibrium rate which has triggered fears that high price inflation will spill over into wages,” says Commerzbank’s economists, “but this is clearly not happening, indeed, the normal link seems to have broken down.” And Commerz sees little to suggest the situation will improve: “Although CPI inflation has picked up following the sterling-induced pickup, we remain sceptical that the pass-through to wages will occur anytime soon,” and this gives the BOE more room to wait before hiking rates.

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- The value of Broadbent's speech should not be underestimated: The June meeting saw the MPC vote by a margin of to 5-3 to hold rates; granted all three of the dissents were from external members, and one of those votes was from a known hawk who has now left (Forbes). Additionally, the Bank's chief economist Andy Haldane, has turned to the hawkish wing of the MPC, aNPnd there is still the unknown quantity, Silvana Tenreyro, who was recently appointed to the MPC (though word on the street has tagged her as a dove). There was (and some say, still is) a risk that if the hawkish voices crowding out Carney's arguments present serious questions about his ability to influence the committee, undermining his position as Governor; Broadbent's comments, however, have put paid to that theory for now.

**SWISS NATIONAL BANK (SNB)**

- SNB watchers have had little to sink their teeth into this week. The Swiss unemployment rate fell to 3.0% from 3.1%, though was unchanged at 3.2% on a seasonally adjusted basis. Producer prices, meanwhile, fell 0.1% in June, slightly better than the -0.3% in May, though the Y/Y rate was unchanged at -0.1%, continuing to point to deflationary pressures within Switzerland.

**RESERVE BANK OF AUSTRALIA (RBA)**

- Minutes from the RBA's latest policy meeting are on the slate for release next week. At the meeting, the central bank held rates at 1.50%, though the post-meeting statement did surprise some given the apparently neutral tone.

- This may have disappointed some, according to HSBC's RBA watcher Paul Bloxham: "Unlike a number of other central banks that have turned hawkish in recent weeks (including Bank of Canada and Norges Bank), the RBA maintained a clear neutral stance." And Though the post-meeting statement was similar to the previous month, in "classic style", the central bank didn't give any forward guidance. "Despite the improving labour market numbers, the RBA stuck by its previous phrasing of 'indicators of the labour market remain mixed' and that wages growth remains low and 'that this is likely to continue for a while yet'," Bloxham noted. HSBC believes the RBA's next move will be to lift rates in Q1 2018.

- In the week, RBA's Debelle and Bullock are due to speak.

**RESERVE BANK OF NEW ZEALAND (RBNZ)**

- Next week, inflation data out of New Zealand is expected to show Q2 CPI decelerating to 0.2% Q/Q (versus 1.0% in Q1) and 1.9% Y/Y (from 2.2% in Q1). "As the RBNZ expected 2.1% Y/Y CPI in the May MPS, a softer outcome justifies Governor Wheeler remaining neutral at the August MPS and through to his late September retirement," TD Securities writes.

**NORGES BANK**

- Although headline inflation slowed in June, the data did come in above estimates, with the fall being driven by energy. The Norges Bank's preferred gauge, however, was unchanged at 1.6% Y/Y, leaving the Q2 average below the central bank's own forecasts.

- Analysts at Capital Economics argue that there is little to suggest the trend will meaningfully turn any time soon, and see inflation falling further in 2017. Accordingly, the consultancy reiterates its view that Norwegian rate hikes are a long way off.

**RIKSBANK**

- Sweden's CPIF inflation came in above the Riksbank's forecast (1.9% Y/Y vs 1.7% forecast); the core measure was also a slightly ahead of expectations. The data adds to the case that the Riksbank will begin to tighten policy, with some forecasting that it will adjust rates before the ECB.

- "The inflation print re-enforces our view of a 10bp rate hike by the Riksbank in Q2 2018 (the April meeting), ahead of the ECB's June meeting," write analysts at Barclays. "Persistent inflation in the next months, however, adds risks of an earlier move. Moreover, a continued confirmation of the advanced cyclical position of the economy likely will lead to even stronger SEK appreciation."