First Abu Dhabi Bank

Market Insights & Strategy

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The House View on Rates (June 2019 update)

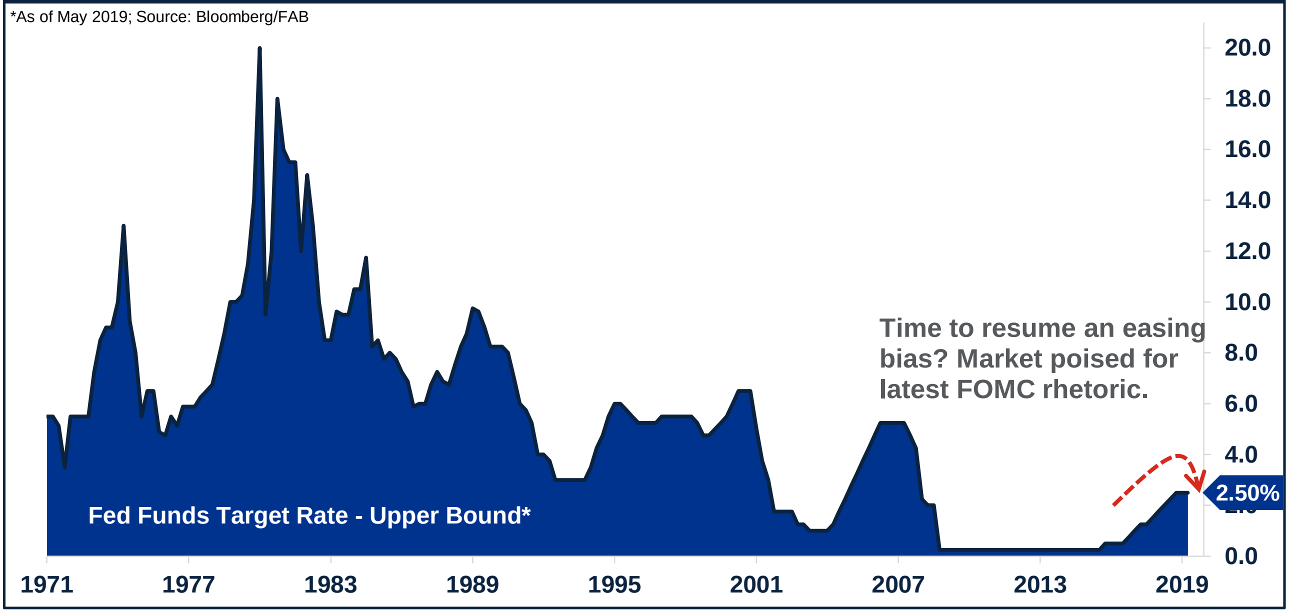
Updating the FAB 'House View' on U.S. / Eurozone / U.K. Rates

Please find below the latest update to our newly inaugurated publication of First Abu Dhabi Bank's 'house view' on U.S., Eurozone and U.K. interest rates. For each central bank (Fed, ECB and BOE) we discuss any recent changes in macroeconomic conditions, challenges and opportunities facing policy makers and set out our adjusted 12-month outlook expectations for rates. We will continue to update our 'house view' on a regular basis and aim to convey changes and confirmation to you in a timely fashion.

U.S. Rates

- **Bottom line**: **We have revised down our outlook on the Fed to take into account the recent rise in macro-economic challenges, dovish money market pricing levels and near absence of inflationary pressures. We now expect the Fed to ease policy by 25bps at the conclusion of the July 31 FOMC meeting, but more as a result of market 'bullying' than because of any significant deterioration in broad macroeconomic fundamentals .**
- OIS markets are currently pricing in some 100bps of rate cuts from the FOMC in the next 12months and a near full 25bps are priced in for July. Anything other than a cut next month therefore could be a major disappointment to the market.
- The Fed does now appears to be being backed into a corner by the markets and forced to yield a sympathetic rate reduction in July; but this will not mark the beginning of a new rate reduction cycle.
- With the Fed having initiated 9 interest rate increases between December 2105 and December 2018 – putting 'insurance' ammunition back into its monetary policy ordnance – we now believe it will be wise to redeploy some of that accommodation in a 'dovish insurance play'.
- This said, given the robust nature of underlying U.S. macro data – including a tight labour market with the unemployment rate at a 50 year low of 3.6% - we would not interpret a July rate hike as marking the start of a sustained tightening programme. We would see a rate cut as 'reverse insurance' move.
- To be clear, we still believe that talk of U.S. recession and demise of the U.S. economy and dollar have been overdone and that the recent inversion of the U.S. yield curve has been the result of self-fulfilling overly bearish prophecy.
- Longer-term, as the macro backdrop stabilises and investor concerns recede, we believe that the (data-dependent) Fed will look to shift back toward a tightening bias, although any actual tightening of policy may not now occur until late 2020 or 2021. This should result in a gradual re-steepening of the yield curve; led by the longer tenors, with front end yields anchored.

Doves take flight



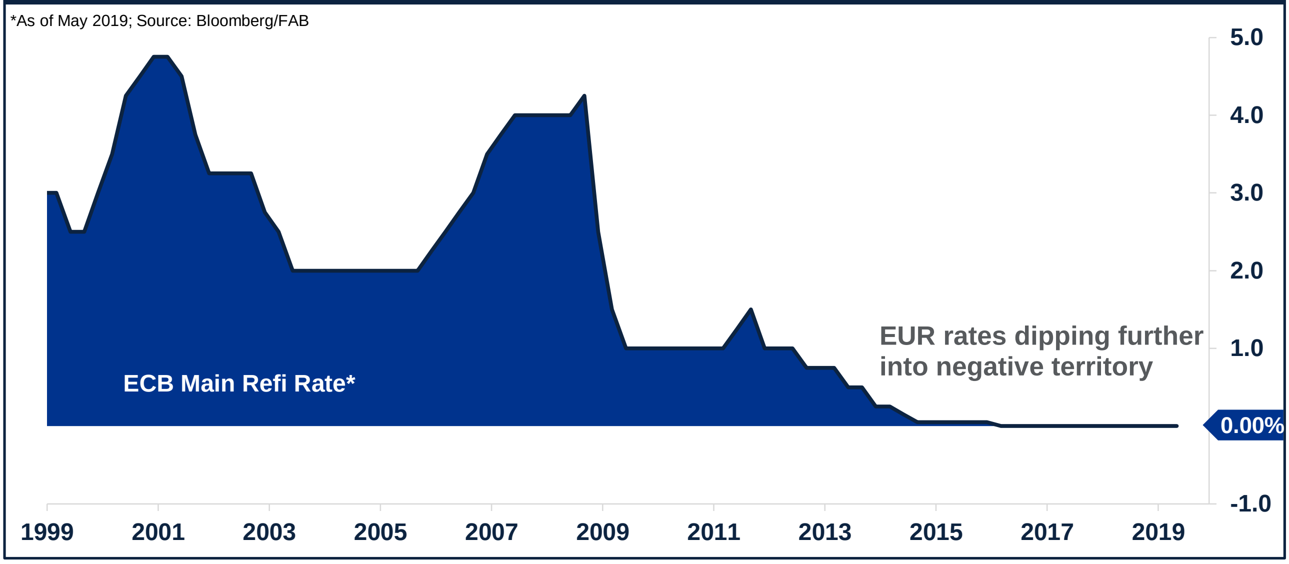
U.S. Rates Analysis

- Latest U.S. Empire Manufacturing report may prove to have been a timely reminder for the Fed of the fragility of the U.S. economic outlook. The index came in at a shocking -8.6 in June, its lowest print since October 2016, down from +17.8 in May and far weaker than expectations (+11.0) and as such may have sealed the deal for a Fed rate cut next month
- With some 100bps of cumulative FOMC rate cuts currently priced into the market and a 25bp cut now nearly fully priced in for July, we believe that Jerome Powell and the FOMC will seek to send a data-dependent, cautiously dovish message to the markets over the coming weeks, so as not to spook the market in either direction, but nonetheless leave the way clear for lower interest rates compared to previous Fed rhetoric.
- Paradoxically, if the Fed were to make a sudden, dramatic shift in direction toward a full-on easing bias, we believe that this could be even more disruptive to the risk asset space in the near-term than not acknowledging any macro weakness at all.
- Other than the latest manufacturing reports (May Empire manufacturing and ISM manufacturing) and global trade concerns weighing on sentiment, the underlying macro position of the U.S. economy has remained reasonably robust in recent months – especially in terms of labor market strength, which directly feeds consumer spending and then GDP.
- As such, we maintain our belief that talk of U.S. recession and demise of the U.S. economy and dollar have been overdone.
- Indeed, just talk of recession seems to have been a self-fulfilling prophecy in recent weeks, accentuating (U.S.) yield curve inversion, without fundamental justification.
- Given the apparent level of ‘Fed bullying’ by the markets we would suggest that one possible saving grace could be the G20 meeting in Osaka, Japan on June 28-29. If the U.S. and China are able to strike a trade deal on the sidelines of the summit, as some suggest will be a key aim of both sides, then we would expect to see a relief rally in markets and a sharp repricing of the interest rate curve and a swift fade of rate cut expectations

Eurozone Rates

- **Our bottom line**: **We argued previously that the net hawkish bias being conveyed by the European Central Bank was unjustified and unsustainable and that the Bank had been premature in calling an end to its QE/asset purchase program at the end of last year. In our view, as Eurozone macro fundamentals weakened, the Bank would be forced to revert to a more dovish position**.
- In its latest outlook for the Eurozone economy, the European Central Bank (ECB) has indeed stated that it is once again open to the idea of renewed monetary policy stimulus
- The ECB previously stated that Eurozone interest rates could be on hold 'through the summer of 2019', but in his June 18 statement, President Draghi stated that the Bank might be about to embark on a new dovish phase of monetary policy.
- The ECB seems set to execute a further deposit rate cut if risks materialise sufficiently between now and September; September is the president's penultimate meeting before he steps down at which time he will also have the additional macro clarity of the new staff projections.
- So the ECB has re-opened the door to potentially more QE, although we would argue that a deposit rate cut would be the most likely first move – and probably just by 10bps so as not to unnerve markets
- ECB seems to suggest that because inflation has been below target for such a long time, that it may allow it to trade above target for an extended period going forward, in order for it to balance out around the 2% target. We interpret such a line of thinking as a significant dovish shift in the Eurozone rates outlook.

Heavily Anchored



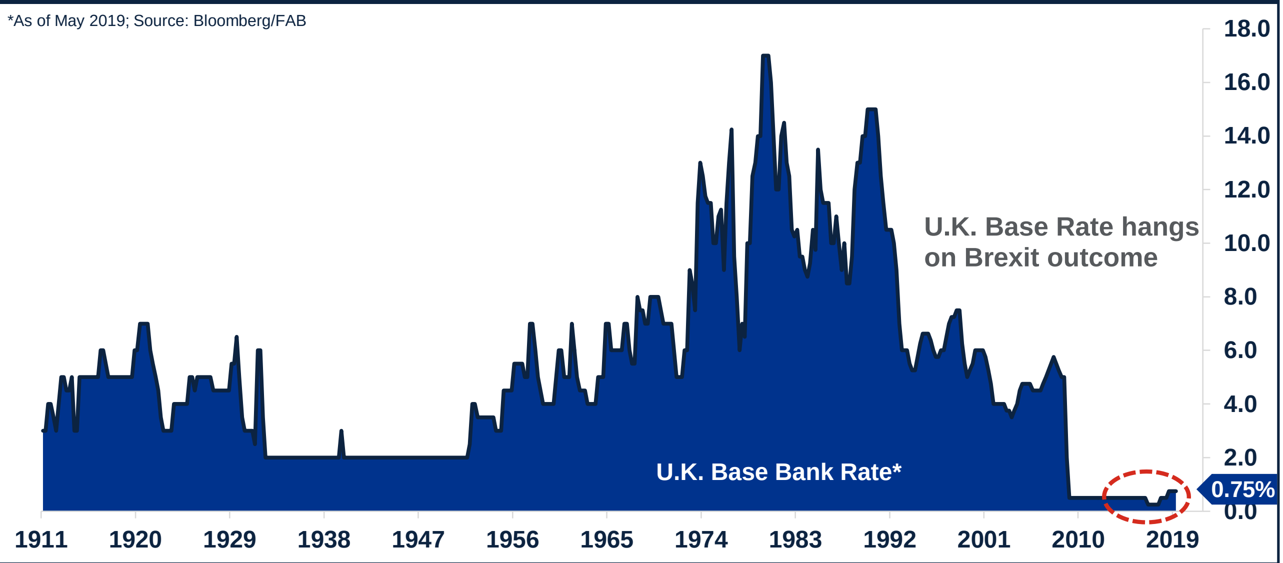
Eurozone rates analysis

- The fragile nature of the Eurozone economy is now experiencing 'slower growth momentum', with the former engine of growth – Germany – recently flirting with recession
- Pressure is building on the ECB to offer new policy accommodation during 2H2019 and into 2020.
- German GDP growth plummeted from +2.3% to an anaemic +0.9% during 2H2018. Consequently, the Central Bank has had to make a 180 degree change to its earlier plans to tighten policy over the coming months. The path of least resistance for ECB interest rates on its main refinancing rate, marginal lending facility and deposit facility is now lower.
- In an effort to underpin generic market sentiment, ECB policymakers are now seeking new stimulus packages. One example of stimulus already introduced by the ECB this year was a series of quarterly targeted longer-term refinancing operations (TLTRO-III), designed to stimulate bank lending in the euro zone. The program is set to start in September 2019 and end in March 2021.

U.K. Rates

- **Our bottom line**: **Our outlook for U.K. rates is little changed this month. The market is still polarized and dependent on the outcome of the Brexit polemic.**
- Sentiment in the near-term is being buffeted by political uncertainty amid the Conservative Party leadership contest and the varying degrees of 'Brexiteer-ness' associated with the candidates
- A 'soft' Brexit or no Brexit could fuel renewed economic expansion and consumer confidence, even if the market doubts this will be enough to support the notion of the Bank of England adopting a tighter monetary policy bias. Futures market has no U.K. rate rise priced in for as long as 10yrs.
- We continue to believe though that a 'hard Brexit' scenario would likely result in the BOE cutting rates in an effort to underpin a much weaker macroeconomic outlook over the next couple of years.

In the Brexit balance



U.K. rates analysis

- The U.K. economy has proved resilient to global macro challenges in recent months with robust labour market conditions, which has fuelled a tighter bias in terms of the U.K. interest rate outlook. This said, the Bank of England's flexibility to respond to improving macro fundamentals is being severely constrained by Brexit uncertainties. In the absence of Brexit, we believe that the BOE would have raised U.K. base rate at least once in the past 6 months.
- Note that the U.K. RICS Residential Market Survey for May showed an increase in the net balance of surveyors reporting a rise in house prices over the last three months to -10 from -23 in April, above the consensus, -21; an apparent sigh of relief with the Brexit deadline being extended to October 31
- The current outlook for U.K. rates now depends on the outlook for Brexit. A smooth, negotiated exit from the EU would likely give the Bank the confidence to tighten in 2H2019 as the economy breathes a sigh of relief. Conversely, a 'hard Brexit' scenario – that we still see as a likely outcome – would severely curtail any BOE tightening aspirations. A disruptive, no-deal Brexit would likely see the BOE cutting rates in an effort to support the economy

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