Market Insights & Strategy

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The House View on Rates

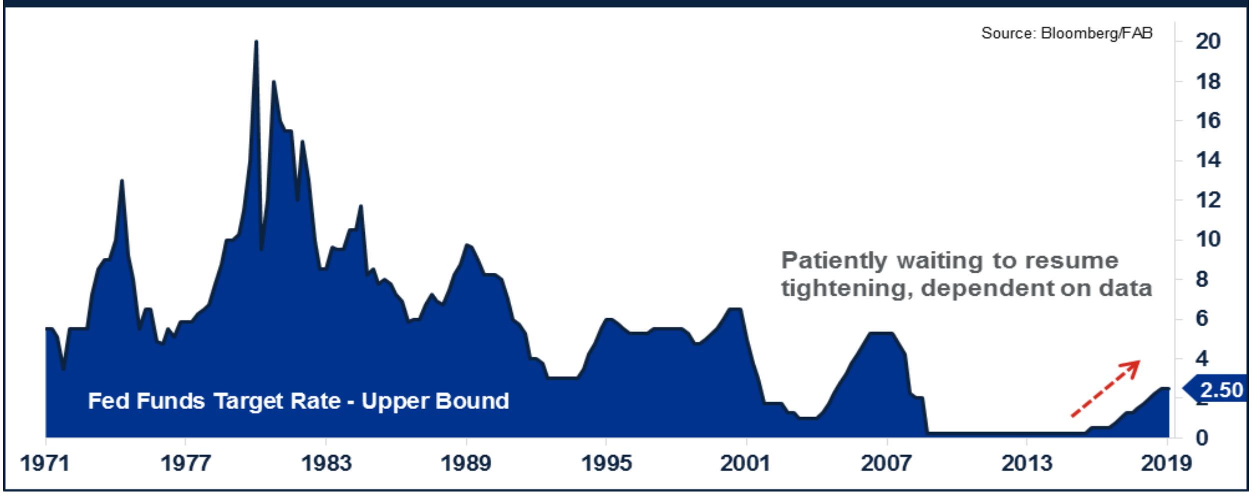
Establishing the FAB 'House View' on U.S. / Eurozone / U.K. Rates

Please find below 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 current macroeconomic conditions, challenges and opportunities facing policy makers and set out our 12-month outlook expectations for rates. We will update our 'house view' on a regular basis and aim to convey changes and confirmation to you in a timely fashion.

U.S. Rates

- **Our bottom line**: We expect the next move by the Fed to be a rate increase, not a rate cut. However the FOMC is not expected to resume its tightening bias until perhaps well into 2020. The Fed has reiterated its data-dependent approach to monetary policy and its ability to be patient in tightening. But, to be clear, we do 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. curve was overly bearish.
- Underlying economic conditions remain firm, but the rates outlook is also being impacted by the various challenges currently facing the global economy, including the U.S./Sino trade dispute, impact of earlier monetary tightening and balance sheet normalization policies. Overall therefore, we see the path of least resistance for rates over the coming months as being higher for choice, led by the longer tenors as front end yields remain anchored, in turn resulting in a gradual re-steepening of the yield curve.

Bias to tighten

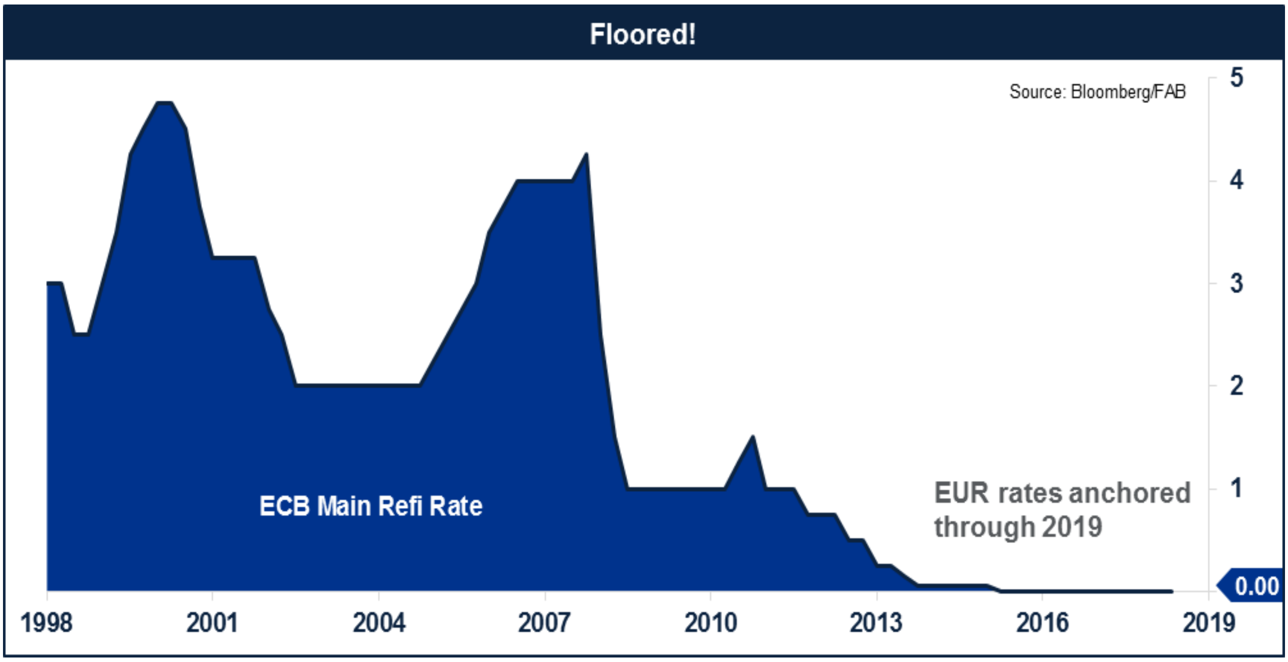


U.S. Rates Analysis

- The underlying macro position of the U.S. economy has remained robust in recent months - especially in terms of labor market strength, which directly feeds consumer spending and then GDP. As such, we have reiterated in recent weeks 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.
- Notwithstanding that the Fed seems to have rates very much on hold for now, we believe that just a few additional improving macro data points will see sentiment swing in favour of the next FOMC rate move being a hike. We have suggested previously - and continue to believe - that the next move by the FOMC late this year or early in 2020 will be a rate increase, not a cut.
- Recent U.S. Q1 GDP data added credibility to our line of thinking. Consensus had been for an expansion of 2.3% (QoQ annualized) in March, up marginally from February's +2.2% reading. In the event, the number actually came in at a very impressive +3.2%.
- But let's not get carried away with the GDP data; as always the devil is likely in the detail. In this respect, some of the elements of the report that were a fillip for GDP in Q1 – especially inventory building in the face of escalating trade concerns as well as expedited imports ahead of potential tariff impositions – could prove to be more of a drag in Q2. If we are correct and there is an easing of trade tensions over the coming months then industry may begin to normalize operating conditions, with inventories being pared back as defensive sentiment recedes.
- Moreover, we note that consumer spending – the most significant contributor to economic growth – eased for the third straight quarter in Q1 while, according to Bloomberg, nonresidential business investment grew at the second-slowest pace in 2 years. As such, we are mindful that Q2 U.S. GDP could be lower again; we estimate U.S. growth reverting back toward to the 2.0% level. Nonetheless, this would still be far from recession territory and should leave the tightening bias in place

Eurozone Rates

- **Our bottom line**: The European Central Bank (ECB) has stated that Eurozone interest rates will be on hold 'through the summer of 2019', but we do not see any meaningful probability of a move (higher) in rates before 1H2020 at the very earliest. The Bank has its hands tied having advocated a shift toward a tightening bias just as the Eurozone economy showed renewed deterioration.
- The ECB has had to scale back its earlier, optimistic, hawkish rhetoric as the macro backdrop weakens. The Bank will now spend the coming months searching for dovish solutions to the growing macro malaise.



Eurozone rates analysis

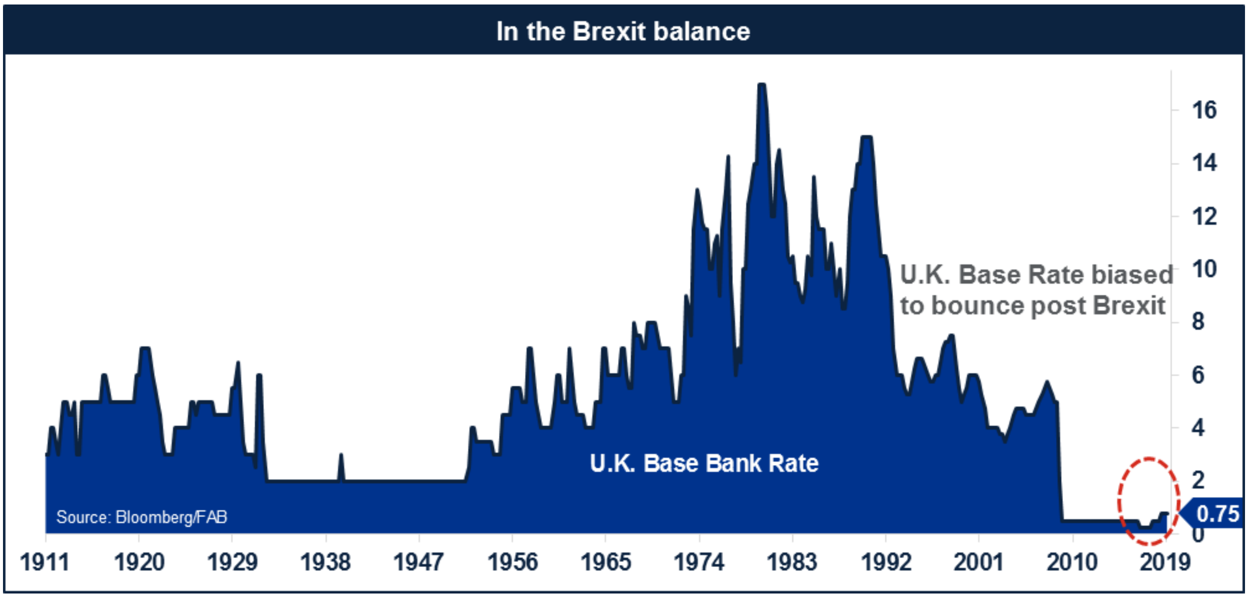
- The fragile nature of the Eurozone economy is now experiencing 'slower growth momentum', with the former engine of growth – Germany – now flirting with recession, suggests that the ECB will remain on hold throughout this year and perhaps into 1H2020. German GDP growth plummeted from +2.3% to an anaemic +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. We expect ECB interest rates on its main refinancing rate, marginal lending facility and deposit facility to remain unchanged at 0%, 0.25% and -0.40%, respectively throughout 2019.
- If anything, the recent decline in generic market sentiment and challenges facing the global growth outlook will support the notion that ECB policymakers may need to unveil new stimulus packages in the coming months. One example of stimulus introduced by the ECB this year was a series of quarterly targeted longer-term refinancing operations (TLTRO-III), which are 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**: The outlook for U.K. rates is polarized and dependent on the outcome of the Brexit polemic.
- A 'soft' Brexit or no Brexit could fuel renewed economic expansion and consumer confidence and support a shift tighter by the Bank of England. A 'hard Brexit' scenario though would likely result in the BOE cutting rates in an effort to underpin a much weaker macroeconomic outlook over the next couple of years.

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.
- 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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