

Market Comment | Fed's hawkish tone raises yields and USD

Global Financial Markets Unit
18 May 2016

- **More hawkish tone from Fed officials.** The hawkish tone of last night's remarks by Fed officials contradicted market expectations of just one rate hike this year. **Kaplan** advocated for an interest rate hike in upcoming months' meetings. "Whether that's June or July, I can't say right now." Atlanta Fed President **Dennis Lockhart** also contributed to increasing expectations of a faster tightening process, saying that two or three rate hikes within this year were still possible - "I think it certainly could be a meeting at which action could be taken," and San Francisco Fed President **John Williams** said that the Fed's current forecast "seems reasonable" (at least for 2016).
- **Negative inflation in the euro zone.** Euro zone CPI final data confirmed the deterioration in April as expected, returning to negative territory (by -0.2% YoY; previous: 0.0%). This decrease was due to the contribution of energy prices (-8.7% YoY) and the slowdown in the positive trend in services (+0.9% YoY; previous: 1.4%).
- **Japan's GDP returns to positive territory.** Japan showed a bigger than expected increase in preliminary 1Q16 GDP (by 0.4% QoQ; consensus: 0.1%). The improvement in the Japanese economy was driven by the recovery in private consumption (+0.5% QoQ; previous: -0.8%) and the stability in public consumption (at 0.7% QoQ).
- **US yields increased and the USD strengthened on hawkish Fed comments ahead of FOMC minutes.** The main driver in financial markets today (and late yesterday) was the hawkish tone that some Fed official used in their public statements. While the market is pricing in an increase of just 25 bps in the US official interest rate this year, some Fed officials showed considerable confidence in a faster pace in the tightening process than expected by the markets. The speakers insisted that two or three rate hikes this year were possible, and this contributed to modifying the market's expectations regarding the Fed's path (June rate hike: 16% -+8pp-, September rate hike: 52% -+6pp-). This tone had a significant impact on financial markets, especially on assets highly correlated with US interest rates. FOMC minutes (to be published later today) will be another input to market players to hint at the Fed's pace. Against this backdrop the US interest rate curve increased in all its tenors (10Y: +4 bps) and pulled up European curves (GER 10Y: +3 bps FRA 10Y: +4 bps ITA 10Y: +3 bps SPA 10Y: +3 bps POR 10Y: +2 bps). Oil price volatility persisted and when the oil price was below but close to the 50 USD/bb threshold, it turned down due to the unexpected increase in US oil inventories. It moderated the gains in some equity indices although it seems that the upward trend in oil prices will continue ahead of the upcoming OPEC meeting (2 June). On equity markets, European indices suffered high volatility, and recovered after offsetting the early losses to finish in positive territory (Eurostoxx 50: +0.6% IBEX: +0.9% DAX: +0.5% CAC: +0.5%). The banking sector supported the main indices, while the basic resources sector was the main dragger. In the same vein, US equity markets increased slightly (S&P and Dow: +0.2%) despite Fed officials' hawkish tone. On FX markets, the USD appreciated against all its major peers ahead of the Fed minutes, with the exception of the British pound (EUR: -0.36% JPY: -0.51% GBP: +1.01%). EM currencies

depreciated against the US dollar (RUB: -0.6% BRL: -1.1% CLP: -0.1% MXN: -0.3% COP: -0.6%)
despite the increase in oil prices.

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Table 1

Current level and changes at daily, weekly, monthly and annual frequencies

Index markets (changes in bp)

US S&P 500 (11/11)(10)(21)
 US S&P 125 (11/11)(10)(40)
 US 10yr 1.8 (7) (8) (4) (44)
 Japan Nikkei 225 (11/11)(11)(138)
 UK FT 100 (11/11)(11)(17)
 UK FT 25 (11/11)(11)(132)
 UK FT 100 (11/11)(11)(147)
 Belgium 10yr 3.05 (3) (2) (1)(142)
 France 10yr 3.11 (3) (2) (1)(146)
 Germany 10yr 2.44 (3) (2) (1)(105)
 Health 10yr 3.8 (1) (1)(121)
 Italy 10yr 4.8 (3) (2) (1)(141)
 Netherlands 10yr 3.9 (3) (2) (1)(141)
 Portugal 10yr 3.8 (3) (2) (1)(141)
 Spain 10yr 3.9 (3) (2) (1)(141)

Emerging Markets

Brazil 10yr 7.1 (1)(1)(41)(21)(381)
 China 10yr 4.2 (1)(1)(1)(21)(31)
 Colombia 10yr 6.0 (1)(1)(1)(41)
 Mexico 10yr 6.0 (1)(1)(1)(41)(21)
 Peru 10yr 6.0 (1)(1)(1)(41)(21)

Country risk (changes in bp)

EUR countries: Germany (Agreement)
 Belgium 29 (1)(1)(1)(1)(1)
 France 35 (1)(1)(1)(1)(1)
 Germany 72 (1)(1)(1)(1)(1)
 Ireland 40 (1)(1)(1)(1)(1)
 Italy 22 (1)(1)(1)(1)(1)
 Netherlands 22 (1)(1)(1)(1)(1)
 Portugal 22 (1)(1)(1)(1)(1)
 Spain 14 (1)(1)(1)(1)(1)
 EUR countries: Spain (Agreement)
 Belgium 5 (1)(1)(1)(1)(1)
 France 8 (1)(1)(1)(1)(1)
 Germany 9 (1)(1)(1)(1)(1)
 Italy 10 (1)(1)(1)(1)(1)
 Netherlands 1 (1)(1)(1)(1)(1)
 Portugal 10 (1)(1)(1)(1)(1)
 Spain 44 (1)(1)(1)(1)(1)
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*CDS, EMBI & MSCI indices with one day delay

**Credit spread (BAA) with two days delay

***S&P GSCI with one day delay

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