

Market Comment | Markets continue warming up to the idea of a Fed hike in June

Global Financial Markets Unit 23 May 2016

- The euro zone composite PMI dropped unexpectedly in May (by 0.1 points to 52.9; consensus: 53.2) due to a slight decrease in the industrial sector, weighed down by both weak global demand and European uncertainty. Meanwhile service sector expectations remained stable. Taking into account the PMI data, our model forecasts 0.3% QoQ GDP growth in 2Q16 (see). On another front, euro zone consumer confidence preliminary data surprised positively in May (to -7.0 points from -9.3; consensus: -9.0).
- Hawkish tone of Fed officials persists. John Williams insisted that two rate hikes are possible this year, and said that it will depend on the data. "We still get another month's data before the June (14-15 policy) meeting and we want to analyse that and come to our conclusion," he said. In addition, he considers that monetary policy could be more aggressive in 2017. "Over the rest of the year two or maybe three rate increases, maybe one or two more (than that) next year so maybe three or four next year I think that's still about right," he said. James Bullard, St. Louis Federal Reserve President, highlighted the strength of the US labour market and the good progress made by inflation in its path towards 2%: "U.S. evidence from labour markets, actual inflation readings and global influences suggests the FOMC median projection may be more nearly correct," he said, going on to warn about the threat of maintaining excessively low interest rates for much longer: "I do worry that keeping rates too low for too long could feed into future financial instability even if it doesn't look like we're in that situation today," he said.
- No clear trend in financial assets after a very volatile week marked by the change in Fed officials' tone. Markets have continued the process of repricing financial assets, as today's speeches from Fed officials have continued hinting at a higher probability of a rake hike in June. Meanwhile, concerns about global supply have returned to the markets, as the temporary factors that caused the fall in oil supply (Canada wildfires and the Libya issue) are fading. Iran's determination to increase its oil exports has also weighed on oil prices today. Moreover, the USD's appreciation (EUR: -0.2%, GBP: -0.24%) could also be fuelling today's downward trend in commodity prices (Brent: -1.0%). The JPY is the only exception among major currencies. The Japanese currency appreciated (+0.64%) on the back of a better-thanexpected trade surplus, although Governor Haruhiko Kuroda said that there is room for manoeuvre to ease monetary policy further, stating that "If necessary, we can further ease our monetary conditions in three dimensions. Quantitative, qualitative and interest rates." Meanwhile, EM currencies depreciated against the US dollar (RUB: -0.1%, BRL: -1.2%, CLP: -0.4%, COP: -0.2%, MXN: -0.5%) hampered by the deterioration in oil prices. On bond markets, the US treasury curve flattened, with short-term yields increasing by more than long-term yields, underpinned by the increased probability of a rate hike (2Y: +3 bps, 10Y: +1 bp). Meanwhile, European yields inched up, with the exception of Portugal and Greece. (GER 10Y: +2 bps, FRA 10Y: +1 bps, ITA 10Y: +2 bps, SPA 10Y: +2 bps, POR 10Y: -2bps). While Portugal's yields dropped slightly, the Greek yield fell sharply (-19 bps) after the Greek Parliament approved tax increases and a new privatisation fund and freed up the sale of non-performing loans,



which would pave the way for the disbursement of €11 billion from the third bailout package. European equity markets trended downwards (EuroStoxx 50: -0.8%, IBEX: -0.5%, DAX: -0.5%, CAC: -0.4%, MIB: -2.4%), pulled down by the Italian banking sector. The chemical sector was also a significant dragger today on the back of recent M&A movements. Meanwhile, US equity markets remained unchanged despite the hawkish tone of some Fed members.

Updat 17.30 CET 23 May, 2016 Table 1



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*CDS, EMBI & MSCI indices with one day delay
**Credit spread (BAA) with two days delay
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