Fed raises interest rates despite declining inflation

NBK MONEY MARKET REPORT

KUWAIT: Last week, the Federal Reserve decided to keep its plans for the gradual normalization of monetary policy unchanged, despite recent weakness in both activity and inflation. The Fed also continued to signal that it plans to raise rates one more time later this year followed by a further three hikes in 2018 and ultimately towards their longer-run 3.0% estimate. Additionally, members outlined the plan towards balance sheet normalization, stating that it intends to start the unwinding process this year if the economy evolves as anticipated.

Meanwhile, US 10-year treasury yields dropped following the Fed's announcement as recent weak inflation data left investors wondering if the Federal Reserve would be able to hike once more this year. As a result, Fed fund futures are pricing a 16% chance of rate hike in September, indicating doubts over a third hike, which might limit the recent strength in the greenback.

At its latest MPC meeting, the Bank of England provided ahawkish policy signal that they have moved closer to raising interest rates, stating that the bank has become less tolerant towards above-target inflation. The move has surprised the market on the UK policy front and added further to the Sterling's volatility in the near-term. The BoE's signal comes as a surprise in the aftermath of the UK's general election result. The move indicates that the central bank is not overly concerned by the recent political developments.

Meanwhile, recent data in the UK have shown inflation accelerating faster than the central bank projected just last month, with the rate now at 2.9 percent. Citing the pound's recent decline, the BOE said inflation could overshoot the 2 percent target by more than previously thought. In Asia, the Bank of Japan kept its monetary policy unchanged and has upgraded its economic assessment and signaled that growth is shifting into higher gear in its latest meeting. However, Governor Haruhiko Kurod reassured markets that the BOJ will maintain its massive stimulus program with inflation far from reaching the BOJ's 2 percent target, despite other central bank's moving towards gradual monetary policy tightening.

On the currency front, the US Dollar initially gained across the board after the Federal Reserve raised its interest rates. The currency then gained more momentum as initial jobless claims and the Philly-Fed manufacturing index positively exceeded expectations. However, the greenback's strength was short lived as concerns over subdued inflation combined with disappointing consumer confidence and housing data curbed expectations of a further rate hike, pushing the dollar lower.

The Euro opened the week at 1.1193 and reached a high of 1.1295 against US Dollar. However, the pair dropped as the Federal Reserve increased interest rates for the second time this year and managed to reach a low of 1.1130. The currency closed the week at 1.1197.

The Sterling Pound managed to reach a short lived high at 1.2817 at the beginning of the week. However, weak wages combined with political uncertainty pushed the currency to lose its early gains. However, the currency managed to regain its strong footing amid expectations that the Bank of England could increase rates in the near future. The currency closed the week at 1.2780.

The Japanese Yen closed the week as the weakest major currency as other major central banks start to move towards normalizing their monetary loose policies. The pair opened the week at 110.35 and dropped to low of 108.83 as disappointing inflation data pushed the dollar lower. However, the widening divergence in monetary policy between the Fed and the BoJ pushed the pair to a high of 1.1142. The USDJPY lost some momentum and closed the week at 110.91. On the commodities side, oil prices came off their highs and ended the week in negative territory, as investors continued to doubt whether Opec and its allies' global agreement to cut production would be able to overcome the glut in supply amid rising US output. West Texas and Brent Crude closed the week at \$44.74 and \$47.37 respectively.

Fed hikes interest rates as widely expected

The Federal Reserve raised interest rates last week for the second time in three months and said it would begin cutting its holdings of bonds and other securities this year, signaling its confidence in a growing US economy and strengthening job market. In lifting its benchmark lending rate by a quarter percentage point to a target range of 1.00 percent to 1.25 percent and forecasting one more hike this year, the Fed seemed to largely brush off a recent run of mixed economic data. The US central bank's rate-setting committee said the economy had continued to strengthen, job gains remained solid and indicated it viewed a recent softness in inflation as largely transitory.

The Fed also gave a first clear outline on its plan to reduce its \$4.2 trillion portfolio of Treasury bonds and mortgage-backed securities, most of which were purchased in the wake of the 2007-2009 financial crisis and recession. "What I can tell you is that we anticipate reducing reserve balances and our overall balance sheet to levels appreciably below those seen in recent years but larger than before the financial crisis," Fed Chair Janet Yellen said in a press conference following the release of the Fed's policy statement. She added that the balance sheet normalization could be put into effect "relatively soon." The initial cap for the reduction of the Fed's Treasuries holdings would be set at \$6 billion per month, increasing by \$6 billion increments every three months over a 12-month period until it reached \$30 billion per month. Meanwhile for agency debt and mortgage-backed securities, the cap will be \$4 billion per month initially, rising by \$4 billion at quarterly intervals over a year until it reached \$20 billion per month.

NEW YORK: A Snapchat banner hangs on the facade of the New York Stock Exchange. —AP photos

TOKYO: People look at an electronic stock board of a securities firm.

US producer price index stayed unchanged

Producer Price Index for final demand remained unchanged in May. Final demand prices rose 0.5 percent in April and edged down 0.1 percent in March. Year-over-year, the producer price index rose 2.4 percent in May, compared to market expectations for a gain of 2.3 percent and following a 2.5 percent increase in the preceding month.

Meanwhile, the core producer price index, that excludes food and energy, increased by 0.3 percent in May, more than forecasts for a gain of 0.2 percent and compared to the previous month's 0.4 percent rise. Core producer prices rose at an annualized rate of 2.1 percent last month, compared to forecasts for a 2.0 percent increase and a gain of 1.9 percent in April. Core prices are viewed by the Federal Reserve as a better measure of longer-term inflationary pressure because they exclude the volatile food and energy categories. Moreover, when producers pay more for goods, they are more likely to pass price increases on to the consumer, so PPI could be considered a leading indicator of inflation.

US consumer price index dropped

Consumer inflation unexpectedly decline in May, pressured by lower prices of gasoline and goods. The Consumer Price Index fell by 0.1 percent for the month versus an expectation of a 0.2 percent rise. On a yearly basis, the index rose 1.9 percent in May against a 2.0 percent consensus, while core CPI rose 1.7 percent versus 1.9 consensuses. In the retail sector, the industry recorded its largest drop in 16 months as US citizens cut spending at gas stations, department stores, electronics shops and fewer Americans are buying new cars.

US retail sales fell sharply

Retail sales recorded their biggest drop in more than a year in May amid declining purchases of motor vehicles and discretionary spending, which could temper expectations for a sharp acceleration in economic growth in the second quarter. Retail sales fell 0.3 percent last month after an unrevised 0.4 percent increase in April. May's decline was the largest since January 2016 and confounded economists' expectation for a 0.1 percent gain. Year-on-year basis retail sales increased 3.8 percent in May. While some of the drop in monthly retail sales reflected lower gasoline prices, which weighed on receipts at service stations, sales at electronics and appliance stores recorded their biggest decline since March 2010.

EUROPE & UK
Euro Area inflation fell

Euro area annual inflation was 1.4% in May, down from 1.9% in previous month. In May 2016 the rate was -0.1%. European Union annual inflation was 1.6% in May, down from 2.0% in April. A year earlier the rate was -0.1%. These figures come from Eurostat, the statistical office of the European Union. The largest upward impacts to euro area annual inflation came from fuels for transport, accommodation services and heating oil, while telecommunications, garments and social protection had the biggest downward impacts.

The Swiss National Bank leaves policy unchanged

The Swiss National Bank left its benchmark interest rate unchanged at record-low levels and reiterated that it is still prepared to take further action to weaken the franc. In a statement, the SNB said it was keeping its benchmark interest rate unchanged at -0.75%, in line with expectations. The central bank also left the target range for the three-month Libor unchanged at between -1.25% and -0.25%. Furthermore, the accompanying rate statement released after the announcement said that "the Swiss franc is still significantly overvalued." The SNB added that it will "remain active in the foreign exchange market, as necessary," while taking the overall currency situation into consideration.

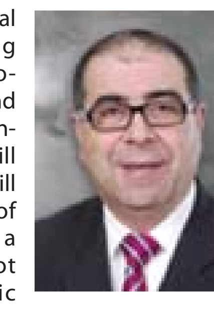
Bank of England shocked markets

The Bank of England shocked financial markets on Thursday when it said three of its policymakers voted for an interest rate increase, the closest it has come to hiking rates since 2007, even with signs of a slowdown in Britain's economy. The surprisingly tight 5-3 vote adds questions over monetary policy to doubt over Britain's political outlook since Prime Minister Theresa May failed to win a parliamentary majority in an election last week. BoE policymakers Ian McCafferty and Michael Saunders joined previous rate rise advocate Kristin Forbes in voting to reverse the BoE's decision last August to cut rates to a record-low 0.25 percent.

Financial markets were pricing in a roughly 50 percent chance of an interest rate hike by next June, compared with 20 percent earlier this week. However, many economists said they still saw no rate hike on the horizon possibly for another two years. Britain's economy slowed sharply in early 2017 as consumers felt the pinch from higher inflation and slowing wage growth. That had led most investors to think it was unlikely that the BoE would quickly follow the lead of the U.S. Federal Reserve which raised interest rates for the second time in three months on Wednesday.

Global economy creating an imbalance in asset classes

By Hayder Tawfik



There are strong signs that global economic activities are picking up nicely. The pick-up in economic growth is spreading widely and evenly. Starting from the biggest economy in the world, US economy is still growing albite not accelerating but still growing and helping pull the rest of the world with it. However, there is a great concern among investors not about the actual global economic growth but about where to invest safely. The problem is to find a new asset class that is safe and gives good return for global investors. There is an imbalance in all asset classes regardless which economy to look at.

Some nations keep accumulating wealth and saving such as Japan and China and Germany but their economies and capital markets lack the sophistication to create local risk free instruments for at least their own savers. As for professional investors, there are diversified investments assets that they can tap into when it is needed. For those economies and some other rich nations, the reliance on the most developed economies to offer them different asset classes continues and this is where the risk to the global economy can happen.

Here I am talking about increase in volatility either in the foreign Exchange, fixed income or the commodity markets. Most of the world's savings and wealth are still parked in the US Treasury market. This can easily be explained by just looking the US yield curve and the very low yield on long term US Treasury. US treasury is the safest asset class in the world but investors can't avoid volatility when the global economy still not synchronized.

Savings glut

The world economy is still facing a savings glut that refuses to go away. This is simply savings that are eating away from accelerating global economic growth and job creations for those nations that faces saving glut. One of the consequences of this is the record low of yield on most developed government bonds even as the Federal Reserve hikes interest rates.

These days, current account imbalances among the US, China and Japan have come down, and Asia's biggest economies are carrying higher debt loads, undermining the idea that there's too much savings. Instead, the problem is that emerging economies haven't yet been able to develop assets that investors are willing to hold as stores of value and collateral when times get tough. Doing that requires strong levels of confidence in the rule of law, equitable regulation and belief that money can be withdrawn by the investor whenever needed.

This problem not only apply to the emerging markets but some others that have huge savings and wealth such as Japan, China and Germany. They still do not have a sophisticated and diversified capital markets that match the real sectors that reflect their economies. The imbalance of a growing economy and underdeveloped capital market, make their savers and investors target the safe-haven assets such as the US Treasuries, German bunds, and the British gilts. These fixed income assets are becoming increasingly rare and in short supply. Obviously offering those savers miserable low yields.

Overseas investors

Purchases by central banks in the developed economies of their own government bonds have made the situation worse for overseas investors. It also made the supply of such government bonds limited. The Federal Reserve is trying to unwind this unusual situation by normalizing its interest rates by raising rates with its attention on plans to dial back its \$4.5 trillion balance sheet.

China, as the world's second-largest economy, offers the best gamble to develop a substitute to the US Treasuries market, though its capital controls have left foreign investors wary to take full advantage of new avenues to invest in its government bonds. China's unpredictable and volatile foreign policy against its neighbors and the US, discourages its domestic and foreign investors to accept Chinese assets haven at least for now. Very strong and dynamic demands have also contributed to the shortage of haven assets. International investors are scared to purchase what was perceived to be haven government bonds in some developed economies that turned out to be less than safe in the global crises. Investing in a world with a more subdued growth path since, investors have piled into assets seen as low risk such as US treasury, Japanese government and German bonds.

China can create an alternative to US Treasury but that is if the Chinese government is serious and able to do so. That will take a long time. The European central bank is giving and encouraging the Chinese government to do so by shifting a small portion of its dollar reserves into the Chinese Yuan. But that's one drop in an ocean of official holdings that's on the rise again. In the meantime, international investors and savers are still chasing haven assets and the worry about the unusual configuration of asset prices and their volatility and reaction to shocks or any bad news goes on.

EXCHANGE RATES

Al-Muzaini Exchange Co.

ASIAN COUNTRIES	
Japanese Yen	2.744
Indian Rupees	4.723
Pkistani Rupees	2.898
Srilankan Rupees	1.985
Nepali Rupees	2.945
Singapore Dollar	221.570
Hongkong Dollar	38.988
Bangladesh Taka	3.763
Philippine Peso	6.100
Thai Baht	8.968
GCC COUNTRIES	
Saudi Riyal	81.147
Qatari Riyal	83.578
Omani Riyal	790.281
Bahraini Dinar	808.020
UAE Dirham	82.850
ARAB COUNTRIES	
Egyptian Pound - Cash	20.050
Egyptian Pound - Transfer	16.737
Yemen Riyal/for 1000	1.221
Tunisian Dinar	124.890
Jordanian Dinar	428.970
Lebanese Lira/for 1000	2.027
Syrian Lira	2.168
Morocco Dirham	31.513
EUROPEAN & AMERICAN COUNTRIES	
US Dollar Transfer	304.100
Euro	343.630
Sterling Pound	391.960
Canadian dollar	231.960
Turkish lira	87.260
Swiss Franc	315.620
Australian Dollar	234.770
US Dollar Buying	302.900
GOLD	
20 Gram	257.580
10 Gram	131.710
5 Gram	66.700

Dollarco Exchange Co. Ltd

Rate for Transfr	Selling Rate
US Dollar	303.900
Canadian Dolla	226.475
Sterling Pound	388.545
Euro	342.155
Swiss Frank	295.810
Bahrain Dinar	806.040
UAE Dirhams	83.135
Qatari Riyals	84.355
Saudi Riyals	81.935
Jordanian Dinar	428.545
Egyptian Pound	16.923
Sri Lankan Rupees	1.988
Indian Rupees	4.725
Pakistani Rupees	2.898
Bangladesh Taka	3.772
Philippines Pesso	6.140
Cyprus pound	167.715
Japanese Yen	3.755
Syrian Pound	2.420
Nepalese Rupees	3.962
Malaysian Ringgit	72.080
Chinese Yuan Renminbi	45.135
Thai Bhat	9.910
Turkish Lira	86.480

Bahrain Exchange Company WLL

CURRENCY	BUY	SELL
	Europe	
British Pound	0.382807	0.392807
Czech Korune	0.004999	0.016999
Danish Krone	0.041708	0.046708
Euro	0. 335870	0.344870
Norwegian Krone	0.031969	0.037169
Romanian Leu	0.084278	0.084278
Slovakia	0.009085	0.019085
Swedish Krona	0.030929	0.035929
Swiss Franc	0.305531	0.316531
Turkish Lira	0.081635	0.091935
	Australasia	
Australian Dollar	0.223343	0.235343
New Zealand Dollar	0.214724	0.224224
	America	
Canadian Dollar	0.225110	0.234140
Georgina Lari	0.137347	0.137347
US Dollars	0.300000	0.304400
US Dollars Mint	0.300500	0.304400
	Asia	
Bangladesh Taka	0.003384	0.003968
Chinese Yuan	0.043216	0.046718
Hong Kong Dollar	0.037098	0.039648
Indian Rupee	0.004250	0.004938
Indonesian Rupiah	0.000018	0.000024
Japanese Yen	0.002663	0.002843
Kenyan Shilling	0.002994	0.002994
Korean Won	0.000258	0.000273
Malaysian Ringgit	0.067304	0.073304
Nepalese Rupee	0.002974	0.003144
Pakistan Rupee	0.002705	0.002995
Philippine Peso	0.006020	0.006320
Sierra Leone	0.000067	0.000073
Singapore Dollar	0.214855	0.224855
South African Rand	0.017726	0.026226
Sri Lankan Rupee	0.001607	0.002187
Taiwan	0.009735	0.009915
Thai Baht	0.008626	0.009176
	Arab	
Bahraini Dinar	0.799209	0.807709
Egyptian Pound	0.014441	0.020349
Iranian Riyal	0.000084	0.000085
Iraqi Dinar	0.000190	0.000250
Jordanian Dinar	0.423553	0.432553
Kuwaiti Dinar	1.000000	1.000000
Lebanese Pound	0.000156	0.000256
Moroccan Dirhams	0.019770	0.043770
Nigerian Naira	0.001257	0.001892
Omani Riyal	0.783450	0.789130
Qatar Riyal	0.079239	0.084179
Saudi Riyal	0.080007	0.081307
Syrian Pound	0.001289	0.001509
Tunisian Dinar	0.120372	0.128372
Turkish Lira	0.081635	0.091935
UAE Dirhams	0.081370	0.083070
Yemeni Riyal	0.000988	0.001068