Weekly Money Market Report
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US Dollar Under Threat From Fed Rate Cuts

>NBK Treasury
+965 22216603
tsd_list@nbk.com

Highlights

- Dollar pressured by rate cut expectations.
- FOMC member Bullard turns dovish.
- US labor report disappoints.
- ECB isn't that dovish after all.
- UK manufacturing sector contracts.
- RBA cuts rate, more to come.

United States

The resilient US dollar has suffered significantly over the past week. After hitting a 1-year high of 98.371 in May, the dollar index has since fallen back sharply towards the 96.450 level. The selloff delivers the first clear indication that the buck is commencing its downward trajectory in response to building Fed rate cut expectations. Up until recently, the US dollar had shown resiliency towards lower treasury yields.

The amplification of Fed rate cut expectations was prompted by dovish comments from St Louis Fed President Bullard who is a voter this year on the FOMC. Bullard said cutting rates "may be warranted soon," due to the elevated economic risk caused by global trade tensions as well as weak inflationary pressures. At the same time, Bullard has been worried about the yield on the 10-year bond, which has fallen below 3-month yield as well as below the federal funds rate itself. It seems that this inversion of the yield curve has become evident enough to reinforce the case for a rate cut. Historically when the yield curve has been this inverted, the Fed has always cut interest rates and delivered a series of rate cuts. Furthermore, the Fed Chairman dropped his typical reference to the Fed being "patient" in approaching any rate decision and mentioned instead that the central bank was watching the fallout from the trade war and would react "as appropriate." It looks like President Donald Trump may finally get the rate cut he has been asking for.

Year to date, the US 2-year treasury yield has fallen around 64 basis points to 1.86% and a 60 basis points drop for the 10-year to 2.08%. The sharp drop is not only attributed to increasing rate cut prospects, but also due to strong demand for safe haven US bonds. Interbank rates have also followed the downward trajectory. The 3-month Libor rate is near an 8-month low at 2.45%, way below the 2.79% seen at the start of the year. The Fed Funds Futures is currently pricing a 98% chance for a cut at the December meeting.

In the FX sphere, the dollar index was further pressured on Friday as the US economy only added 75,000 jobs, lower than the median 185,000 predicted by economists. As for wages, the annual rate dropped from 3.2% to 3.1%, while the unemployment rate remained near a 50-year low of 3.6%. The probability for three or four quarter-point Federal Reserve rate cuts this year jumped higher to 60% after the labor report was released, from 49% seen in the previous session, according to Bloomberg data on federal funds futures. As such, the dollar index was the worst performer in the currencies market losing nearly 1.06% of its value. The DXY opened the week at 97.590 and closed on Friday at 96.544.

In the equities market, the Dow Jones snapped a six-week losing streak and the S&P 500 has risen nearly 5.30% from its lows seen this month. US Federal Reserve officials have hinted the possibility of lower rates to come, while financial markets' tone indicates that a lower overnight rate in the future is certain. Looking at fundamentals, stock prices are inversely related to interest expenses. Hence, the prospect of lower rates to come has opened the green light for US stock markets. The Dow Jones gained 4.65% in the past five trading sessions.

US Manufacturing Sector Losing Steam

As the global economy is evidently cooling down and trade tensions linger on, the US manufacturing sector is under pressure. The ISM manufacturing index fell to 52.1 in May from 52.8, the lowest reading since October 2016. An alternative indicator, the US Markit manufacturing PMI also declined by 2.1 points to 50.5, which was the worst reading since September of 2009. Both surveys have weakened noticeably since late last year. If trade tensions intensify and becomes a norm, the manufacturing sector's direction of travel could be tilted to the downside.

In regards to the service sector, the latest PMI data portrait an optimistic picture as the PMI reading rose to 56.9 in May, from 55.5. It looks like the service sector is doing the heavy lifting for the economy, which accounts to nearly 80% of US GDP. The overall economy has grown at a healthy pace in recent quarters, though underlying signs suggest growth is slowing. A weaker manufacturing sector, subdued inflation and the recent private sector just hiring 27,000 versus expectations of 185,000 are signals that the largest economy is losing momentum.

Europe

Euro Appreciates after ECB Meeting

The ECB's governing council maintained its loose monetary policy last week as expected and pushed back the timing of its interest rate hike. Governing officials at the ECB pledged to keep rates at their current levels at least through the first half of 2020, instead of the end of this year as it had said only back in March. As for rate cuts, the head of the ECB stated that officials had addressed the Bank's readiness to act in case of "adverse contingency" and several governing members had raised the possibility of additional interest rate cuts or even restarting asset purchases. Current money market futures are pricing in a 45% chance of a 10 basis point cut in ECB rates by the end of 2019. In the meantime, the central bank will support the single economy through (TLTRO-III), which provides cheap financing to credit institutions and banks. The lending rate to the euro-zone banks has been established at 10bps above the average main refinancing rate (currently 0%), however if lending exceeds a certain benchmark, then 10bps above the marginal deposit rate (currently -0.4%) will be applied.

Looking at ECB predictions, growth was slightly revised higher to 1.2% for 2019, although for 2020 and 2021 GDP was downgraded to 1.4%. Prices are now seen rising just 1.3% this year, 1.4% next year and 1.6% in 2021. Economic data out of the euro-zone has been frail indeed with the manufacturing sector in negative territory, weak growth and a subdued inflation. The most recent inflationary readings disappointed to the down side after headline CPI dis-inflated from 1.7% to 1.2% and core price growth tumbled from 1.3% to 0.8%. Moreover, the global trade war displays no sign of scaling down, Italy is once again in conflict with the European Commission, German industry continues to post dismal figures, stock markets are continuously in the red and a hard Brexit may just be around the corner. Providing banks with cheap funding maybe the only solution at the moment, especially with rates already at 0% and no fiscal levers to pull, options are somewhat limited. With universal uncertainty already harming trade, major central banks like the ECB and the US FED seem to have given up plans to tighten policy.

As for the single currency, the EUR/USD pair soared to a 1.5-month high of 1.1308 after the ECB meeting. The euro appreciated as markets had anticipated an even more dovish motion from the ECB and for the central bank to acknowledge softness in economic growth. Money market futures are now pricing in a 45% chance of a 10 basis point euro-zone rate cut by the end of year versus 75% before the ECB statement. In addition, the dollar was softer across the board on lower treasury yields, paving the way for the single currency to appreciate. Over the past five trading session, the euro gained 1.44% over the USD and was the second best performing G10 currency in the FX market last week.

UK Manufacturing Sector Contracts

Britain's manufacturing segment contracted for the first time in almost three years as the index fell from 53.1 to 49.4. The shrinkage in the manufacturing sector was attributed to diminishing Brexit related stockpiling, weaker global demand and most importantly the Brexit conundrum. Several firms surveyed in this reading conveyed that some clients had diverted supply chains away from the UK as a result of an uncertain Brexit outcome. The boost from stockpiling was expected to be temporary, while quarterly growth is expected to slow to 0.2% in the second quarter, the Bank of England said in its latest inflation report.

As for the services sector, the PMI data improved to 51 from April's 50.4. In spite of the uptick in services activity in May, the average for the sector so far in 2019 is 50.3, down from the 2018 average of 53, elevating fears for the health of a sector that accounts for about 80% of UK economic output. The dominant service segment is still suffering a potent cocktail of depressed demand and uncertainty. A sharp depreciation in the Sterling pound since the referendum is increasing transport and input costs, while staff wages are increasing. As a result, service companies are under immense pressure. The progress in the sector's activity in May was counterbalanced by worsening manufacturing and construction PMI indices, which both dropped below the 50 mark indicating a contractionary environment.

Overall, a slowdown in the global economy and worldwide trade tensions escalating combined with Brexit uncertainties increases the probability that the UK manufacturing sector could remain in contraction territory. As such, a rate hike from the central bank seems farfetched at the moment.

In regards to the Sterling pound, the GBP incurred its first weekly gain in five weeks against the USD. The positive momentum is attributed to dollar weakness rather than markets feeling more confident that Britain can avoid a no-deal Brexit. The pound gained 0.77% versus the USD last week. The CHF also took advantage of the dollar's weakness and found further support due to its risk aversion demand. The USD/CHF pair ended the weekly session at 0.9876, a 1.20% loss for the dollar in weekly terms.

Asia

Aussie Perseveres Despite Rate Cut

The Australian dollar was barley impacted by the RBA's decision to cut its cash rate by 0.25% to 1.25%, which is the first policy rate move in nearly three years. Markets have been expecting the loosening of monetary conditions as the overnight indexed swap (OIS) was 102% priced for a 0.25% cash rate cut just before the announcement. Furthermore, in the Bloomberg survey, 36 of 38 economists had expected a cut. Thus, the perseverance of the Aussie dollar was partly due to an already priced in scenario and a weaker dollar across the board. The AUD/USD rose to a high of 0.7004 after the rate cut decision.

It is still all about the labor market the RBA noted; the RBA cut its cash rate to upkeep employment growth and provide greater confidence that price growth will be consistent with the 2-3% target objective. In addition, the RBA expressed concern that recent inflationary results have been lower than projected, however they still expect inflation to pick up. Underlying inflation is forecasted at 1.75% in 2019 and 2.00% for 2020. The Australian rate market is also predicting a further rate cut this year to 1% during the second half of this year. Hence, with more room for the Bank to ease monetary policy amidst increasing downside risks stemming from trade disputes; recent modest Aussie gains are built on shaky foundations.

Looking at the preferred safe haven currency, the yen has soared tremendously in response to the latest re-intensification in trade tensions between the US, China and Mexico. Therefore mounting downside risks to the global growth outlook have encouraged a pick-up in safe haven demand for the yen. During May the yen strengthened against the US dollar from 111.37 to 108.68. The USD/JPY depreciated to a five month low of 107.80 last week.

Commodities

Opportunity Loss of Holding Gold Diminishes

In the commodities complex, gold prices soared to $1,348.08 last week, the highest level in 14 months. Declining US interest costs has made the yellow metal more attractive as the opportunity loss of holding it has diminished. Ever-growing expectations for a US rate cut and concerns that the trade war rhetoric could hit global growth boosted demand for the safe haven metal. On a weekly basis, the price of gold surged 2.52%.

Kuwait

Kuwaiti Dinar at 0.30300

The USD/KWD opened at 0.30300 Sunday morning.

Rates –09 June, 2019

	Previous Week Levels				This Week's Expected Range		3-Month
Currencies	Open	High	Low	Close	Minimum	Maximum	Forward
EUR	1.1170	1.1347	1.1158	1.1331	1.1135	1.1535	1.1419
GBP	1.2635	1.2762	1.2607	1.2734	1.2635	1.2935	1.2793
JPY	108.25	108.61	107.80	108.18	106.15	109.20	107.46
CHF	0.9996	0.9999	0.9851	0.9876	0.9675	0.9975	0.9802