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Weekly Money Market Report
22 May 2022

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Central Bankers Vow to Raise Interest Rates

Highlights

- **Federal Reserve Chair Jerome Powell pledges that the US central bank would ratchet interest rates as high as needed.**
- **American consumers continued to pump money into the US economy raising retail sales.**
- **The European Central Bank is expected to raise the deposit rate for the first time in over a decade.**
- **Bank of England Governor Andrew Bailey warned of a "very real income shock" stemming from energy & "apocalyptic" food prices.**
- **Inflation in Japan rose to 2.5%, exceeding the central bank's target for the first time since 2014.**

United States

As High As Needed

Federal Reserve Chair Jerome Powell on Tuesday pledged that the US central bank would ratchet interest rates as high as needed until it sees "clear and convincing" evidence that inflation is coming back down towards the US central bank's longstanding 2% target. Powell affirmed the central bank's commitment to taming price pressures, saying restoring price stability was essential to the smooth functioning of the economy and vowing to raise interest rates to a level that actively constrains demand if necessary.

The Fed has raised interest rates by 0.75 of a percentage point since March from its near-zero levels that had been in place for roughly two years. Further 0.5% rate rises such as the one the central bank implemented earlier in the month are likely, with at least one more in the next month and a possibility of another in the following month. The Fed may also consider a fourth half point rate rise at its September policy meeting if inflation does not moderate significantly by then, before dialing back the size of its increases to quarter point increments.

Traders now expect the federal funds rate to reach roughly 2.8% by the end of the year, a sizeable jump from its current level of between 0.75% and 1%. If reached, the rate would still be within the 2% to 3% range that Fed officials have previously indicated is considered "neutral" when inflation is at the 2% target. Powell said that the Fed "won't hesitate at all" to raise rates above neutral if warranted by the data, although he reiterated that officials do not know with "any confidence: where that level is, given the strength of the labor market and the extent to which inflation is above the regulator's target. He said the Fed would instead look at how financial conditions and the economy are adapting in real time. Powell added that there are "pathways" for the Fed to damp demand and bring down inflation without substantial labor market losses, although he said the unemployment rate may rise "a few ticks" from its very low 3.6% level today.

The following day to Powell's speech, two US central bankers said they expect the Federal Reserve to downshift to a more measured pace of policy tightening after July, in an attempt to quell inflation without lifting borrowing costs so high that they send the economy into recession. It is not clear if the view that was shared by the Chicago Federal Bank President Charles Evans and Philadelphia Fed Chief Patrick Harker marks a consensus at the Fed for how to bring down the highest inflation seen in 40 years. But it does suggest that while policymakers broadly back using half-point rate hikes to get short-term borrowing costs to a range of 1.75% to 2% over the next two months, support for sticking to that pace beyond July may be limited. Fed Chair Jerome Powell has not been specific about his expectations for the policy path beyond July.

Solid Retail Sales

American consumers continued to pump money into the US economy with retail sales rising 0.9% m/m and 8.2% y/y in April, marking the fourth straight month of higher spending. Data revealed more was spent on restaurants, furniture, clothing, and electronics. Spending on gasoline was cut as prices pulled back briefly in April from the rally owing to the war in Ukraine. Excluding gasoline, retail sales rose 1.3%. Other data added to signals of strong economic momentum, as US industrial production marked its fourth month of gains after increasing 1.1% in April. Looking at the labor market, April marked the 12th straight month of solid job gains sending unemployment close to pre pandemic levels at 3.6%.

Dollar Cool Down

The US dollar kept rising in all but two of the last 14 weeks, and started this week on a firm foot, garnering support from a flight to safety by investors, amid a rout across markets due to fears of the impact of soaring inflation and Russia's invasion of Ukraine. But later in the week, the dollar started to flounder, with the dollar index ending the week 1.26% down at 103.152. The dollar's weakness partly reflected a recent fall in US Treasury yields adjusted for inflation, and is mostly attributed to the recent buildup of long US dollar positions that are weighing on the greenback, raising the question on whether the dollar really has reached exhaustion. Other safe-haven currencies have rallied this week as global equities have come under pressure, the Swiss franc ended the week 2.68% up versus the dollar, while the Japanese yen closed 1.08% up. The euro has also benefitted from the dollar's weakness, closing the week up 1.5%.

Europe

Out of The Negative

The European Central Bank is expected to raise the deposit rate for the first time in over a decade this coming July, and to finally bring it out of negative territory at its following meeting in September. With inflation hitting 7.5% in the Eurozone in April, and almost every other major central bank having already raised interest rates, ECB president Christine Lagarde backed calls for an early rate hike by policymakers last week. The bank is now expected to end its bond purchases programme in July and follow that with a 25 basis-point deposit rate hike a few weeks later. The European Commission cut its growth forecast for the euro zone this year to 2.7% from 4.0% projected in February, and upgraded its inflation forecasts to 6.0% this year from 3.5%.

United Kingdom

Inflation: Rock. Low Economic Growth: Hard Place.

In its monetary policy report hearing, Bank of England Governor Andrew Bailey spoke in front of the Parliament on Monday where he said that he was unable to stop UK inflation from hitting 10% this year, admitting that he sounded "apocalyptic" on food price rises. Senior Tory MPs have been attacking the BoE on its handling of soaring price increases, and Baily accepted that inflation was far too high but blamed global shocks including Russia's invasion of Ukraine.

Bailey insisted the BoE would raise interest rates far enough to ensure UK inflation falls from an expected peak of more than 10% in the fall back to the central bank's 2% target. "The most important thing we can do is to get inflation back to target and to get back to target without unnecessary disruption to the economy," Bailey told MPs. He implied the BoE would not shy away from generating a recession to do that if it was necessary.

The Governor pinpointed rising prices for energy and goods as causes of inflation, and highlighted shocks such as Russian president Vladimir Putin's invasion of Ukraine and the impact of China's zero-Covid policy.

At the time of the hearing, the latest inflation data available was the 30-year high reading of a 7% increase in March, and while the Monetary Policy Committee raised its main interest rate a quarter point to 1% this month, the readings for April came two days following the hearing to show a gloomier picture. Official figures showed inflation in April jumped to 9%, the highest level the country have seen in more than 40 years.

The increase in prices, which is double the amount expected by the Bank of England just six months ago, is being driven by sharp rises in energy costs and the tightest labor market since the early 1970s. At Tuesday, employment figures showed that UK employment fell to its lowest rate in nearly half a century in the first quarter of 2022, as the number of job vacancies rose to a new high of 1.3mn.

Stagflation is on the cards for much of the developed world in 2022, but the UK is especially exposed to a combination of persistently high inflation and low economic growth. Britain is contending with the same shock to energy prices as other European countries, but it also has a labor market more like that of the US, with widespread worker shortages fueling wage pressures.

The BoE has already signaled it will take action to keep the economy weak, taking the view that higher unemployment and financial pain for households and companies are necessary to squeeze inflation out of the system.

At the end of the week, Bank of England's chief economist Huw Pill said that it was "crucial" to ensure that the UK avoids stoking an "inflationary psychology" and indicated he supported further interest rate rises. He said that the BoE was still grappling with the difficult question of how much inflation would fall on its own as household finances were hit hard by the cost of living crisis and how much additional pain was necessary through higher interest rates.

One of the key determinants of how much interest rates would have to rise, Pill said, was whether companies felt they could raise prices without much consequence and whether people thought they could demand higher wages without a fear of losing their jobs. Pill is not seen as one of the most aggressive members of the Monetary Policy Committee and voted for a quarter point interest rate increase this month, unlike three of the nine members who favored a half point increase..

Asia-Pacific

Even Japan

Inflation in Japan rose to 2.5% y/y in April from 1.2% in March, the first time it has exceeded the central bank's target since 2014. Core Inflation (excluding fresh food) rose 2.1% y/y, the fastest rate since 2008. Higher energy and food prices contributed significantly to inflation on a y/y basis. The Bank of Japan is unlikely to adjust its policy in the near term as it is looking for 2% inflation to be maintained over a longer period, and believes the current supply driven inflation will not be sustained.

Kuwait

Kuwaiti Dinar

USD/KWD closed last week at 0.30650.

Rates – 22nd May, 2022

	Previous Week Levels				This Week's Expected Range		3-Month
Currencies	Open	Low	High	Close	Minimum	Maximum	Forward
EUR	1.0404	1.0387	1.0607	1.0560	1.0350	1.0655	1.0613
GBP	1.2233	1.2215	1.2524	1.2487	1.2290	1.2595	1.2494
JPY	129.25	127.01	129.77	127.85	126.90	130.05	127.29
CHF	1.0020	0.9692	1.0064	0.9750	0.9660	0.9960	0.9696