Fed hikes rates for eighth time in three years; Brent crude surges past $80 mark

Overview

The Federal Reserve hiked interest rates by 25 bps to 2.00-2.25%, increased its forecasts for US growth and signaled that rates are likely to rise once more this year and three times in 2019. Despite this bullish outlook, financial markets took the well-trodden move mostly in stride, with yields on 10-year government bonds actually declining on relief that the central bank did not outline a more hawkish path for rates. The US S&P 500 edged lower on the week, but ended September up 0.4% m/m for its sixth consecutive monthly gain.

In Europe however, Italian bond yields surged as the new populist government agreed plans for higher spending and a budget deficit of 2.4% of GDP next year – higher than investors expected, in defiance of the EU and adding to Italy’s already high debt burden. It also puts further pressure on Italian banks that have large holdings of public debt, and risks a downgrade in Italy’s sovereign credit rating.

The price of Brent crude oil blasted through the $80/bbl mark, finishing up 5% w/w just shy of $83/bbl and its highest in nearly four years. Despite another call by US President Trump for lower prices, OPEC and Russia appear in no rush to increase output while concern over a large reduction in Iranian supply due to US sanctions – which Trump last week threatened to escalate further – is mounting. Oil market analysts continue to upgrade their oil price forecasts, but the outlook will depend on the supply response from countries with some spare capacity, notably Saudi Arabia.

In the GCC, most central banks opted to follow the Fed’s move by increasing key policy interest rates. Official lending rates were raised in Saudi Arabia, Bahrain and the UAE, while deposit rates increased in Qatar and Kuwait. The Kuwaiti central bank cited keenness to support non-oil growth whilst maintaining the attractiveness of the dinar as a reason for leaving its lending rate unchanged at 3.0%.

International macroeconomics

USA: In a unanimous vote, the Federal Open Market Committee of the Federal Reserve increased interest rates by 25 bps to 2.00-2.25% and its eighth hike since the beginning of the normalization cycle that started in December 2015. In its

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updated ‘dot plot’ projections, it signaled one further increase for this year in December and three for 2019, and also removed the reference to policy remaining “accommodative” in its accompanying statement. According to Fed Chair Powell, the latter reflected uncertainty over the so-called ‘neutral’ level of interest rates that will match the economy’s long-term performance. The Fed also upgraded its forecasts for GDP growth this year and next (to 3.1% and 2.5%, respectively), projected that the unemployment rate will drop to 3.5% in 2019, while core inflation forecasts were unchanged at 2.0-2.1%. Powell said that there was little discernible impact of the US-China trade war on the economy’s aggregate performance.

Meanwhile, the economic data flow continues to be largely positive. Consumer spending growth moderated slightly to a still decent 0.3% m/m in August from 0.4% in July, while core Personal Consumer Expenditure inflation – the Fed’s preferred inflation gauge – stood unchanged at 2.0% confirming little notable impact so far from this year’s import tariff increases. (Chart 1.) The Conference Board’s consumer confidence measure shot up to an 18-year high of 138.4 in September and now close to the index’s all-time high of nearly 145 registered at the peak of the dot-com boom. The housing market however remains an area of sluggishness for the US economy, with new home sales edging up only slightly in August after a weak June-July and the Case-Schiller index showing house price rises easing to their lowest rate in 11 months at 5.9% in July, affected by rising mortgage rates.

**Chart 1: US inflation and interest rates**

Eurozone: Headline inflation in the Eurozone unexpectedly rose to 2.1% in September, slightly higher than its outturn the previous month and the strongest since mid-2012. Core inflation, however, ticked lower to 0.9%. (Chart 2.) While the overall increase in prices is hovering close to the ECB’s target, supporting its case to unwind its QE program, the stubbornness of core prices still signals caution.

In a move that surprised markets and sparked fiscal concern, the Italian populist coalition government passed a more aggressive expansionary budget than investors expected. The deficit is now penciled to widen to 2.4% of GDP, significantly higher than previous targets and reflecting the party’s commitment to its populist election promises. The move is set to put Rome on a collision course with Brussels, which will review Italy’s draft budget in mid-October. Markets reacted negatively to the news, with investors selling both Italian bonds and equities.

**Chart 2: Eurozone inflation**

GCC & regional macroeconomics

**Saudi Arabia:** SAMA raised both its repo and reverse repo rates by 25 bps to 2.75% and 2.25%, respectively. The 25 bps rise in the repo is the kingdom’s third this year; the first repo rate rise in March pre-empted the Fed’s rate rise in that month amid concerns about capital flight since the 3-month SAIBOR fell below the 3-month USD equivalent LIBOR, by as much as 18 bps, for the first time in years. While it has narrowed from about 50 bps in 2017, the differential is positive and stable at the moment, at around 28 bps. There are concerns about the impact of rate rises on private sector credit growth which remains anemic (0.7% y/y in July).

**UAE:** In line with the US Fed, the UAE central bank (CBUAE) raised interest rates on certificates of deposit, the main monetary policy instrument through which interest rate changes are transmitted to the UAE banking system. The CBUAE also raised its repo rate by 25 bps to 2.25%.

Latest gross credit data showed signs of recovery, with loan growth increasing from 1.8% y/y in July to 3.4% y/y in August, mainly thanks to an improvement in lending to the corporate sector. (Chart 3.) Deposit growth also gained some traction, rising from 6.5% y/y to 7.6% y/y during the same period on the back of higher oil prices, which have led to a rise in government deposits.

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Meanwhile, UAE banks are contemplating asking the CBUAE to ease mortgage lending restrictions in a bid to support real estate activity and ultimately prices, amid growing supply. Banks have proposed increasing the maximum limit that first-time buyers of a home worth up to Dhs 5 million can borrow from 80% to 85% of the property value for UAE citizens and from 75% to 80% for foreigners.

**Bahrain:** Also in line with the US Fed, Bahrain’s central bank raised its one-week deposit facility by 25 bps to 2.25%. It also raised its overnight deposit rate to 2.25% from 2.00%, its one-month deposit rate to 3.25% from 3.00% and its lending rate to 4.25% from 4.00%.

Meanwhile, given its large fiscal and external deficits, Bahrain’s international reserves remain under pressure. In August, however, the kingdom’s reserves jumped to $1.9 billion (1.7 months of imports) from $1.3 billion in July, perhaps on the back of off-the-record funding from Saudi Arabia, the UAE and Kuwait. (Chart 4.)

**Markets – oil**

A third consecutive week of gains for oil prices saw Brent and WTI rise by 3.5%-5.0% w/w to close the week at $82.7/bbl and $73.3/bbl, respectively. (Chart 5.) On Friday, Brent set a new four-year high of $83.3/bbl (intraday trading) after it was reported that Chinese oil refiner Sinopec was looking to halve its imports of Iranian crude; markets had expected China, which is Tehran’s largest customer, accounting for 35% of Iran’s exports, to keep up its purchases of Iranian crude, having previously indicated that it would not bow to the US sanctions line. Earlier, and setting the stage for a bullish end to the week, was the announcement by OPEC+ producers not to open the taps (to offset Iranian and Venezuelan supply losses) beyond what was agreed in June, a decision that drew a stinging rebuke from President Trump that OPEC was “as usual ripping off the rest of the world”. The US also indicated that it would not access its strategic petroleum reserve to help lower prices.
Markets – equities

International markets finished the week down as global trade concerns resurfaced. The MSCI AC world index shaved 0.4% w/w. The S&P 500 and the DJI were down 0.5% and 1.1% w/w, respectively, while European stocks were weighed down by the uncertainty that surrounded Italy’s budget, with the Euro Stoxx 50 retreating 0.9% w/w. Meanwhile, trade tensions pulled the MSCI EM index down 0.6 w/w. (Chart 6.) Regionally, the MSCI GCC index was up 0.4% w/w, with Dubai and Saudi leading the way (+2.2% and 1.7% w/w, respectively). Meanwhile, Kuwait’s All Share index decreased by a small 0.2% w/w.

Markets – fixed income

International bond yields were mixed, with 10-year US government treasury yields registering their 10th consecutive day above 3%, but edged slightly lower on the week to 3.06%, down 1 basis point. In Europe, yields on 10-year Bunds dropped 6 basis points on Friday on growing concerns over Italy’s fiscal sustainability. However, they finished the week up 1 basis point, at 0.47%. (Chart 8.) Regionally, yields on 4-5 year sovereign paper were mixed, with Qatar, Abu Dhabi, and Saudi witnessing drops between 2-8 bps, while Kuwait and Dubai edged slightly higher.

On the quarter, however, strong US economic momentum helped US equities register almost record growth, with the S&P 500 finishing 3Q18 7.9% higher and the DJI up 9.3%, greatly outperforming their global peers. In Europe, slower growth and trade concerns saw the Eurostoxx 50 finish 3Q18 almost flat at 0.1%. Emerging equities, on the other hand, were volatile, affected by short-term debt concerns in Turkey and Argentina, the strength of the US dollar and tighter monetary conditions. The MSCI EM index was down 0.6% q/q. Regional equities were up 0.5% q/q, as Kuwait’s FTSE inclusion and firmer oil prices helped offset the emerging market sell-off. (Chart 7.)