

ECOWEEK

No. 18-31, 31 August 2018

Fed: Avoiding the risks of stargazing

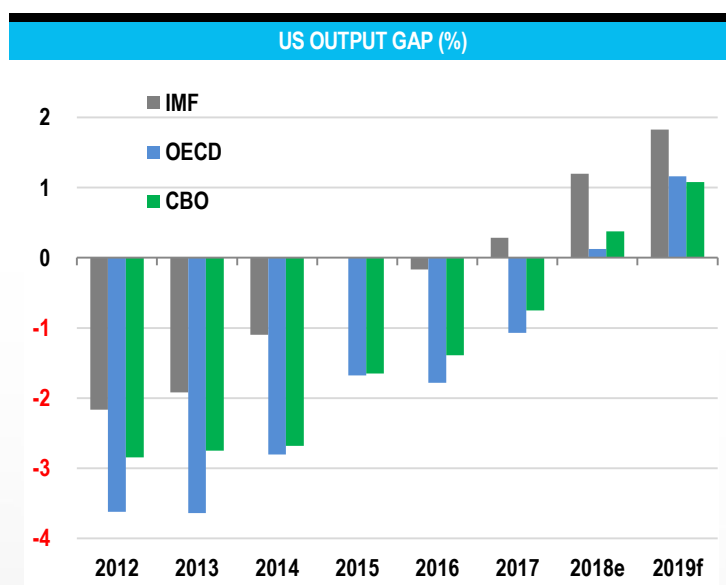
■ In assessing its monetary policy stance, the Fed pays attention to differences between realised and target inflation, unemployment and its natural rate, the policy rate and its neutral rate ■ Estimates of these reference points are highly uncertain ■ For this reason the Fed adopts a pragmatic approach based on data-dependence and gradualism: dovishness still prevails

Gazing stars is dangerous when you walk around because you might hit an object standing in your way. Better watch where you're heading than look at the stars for direction is the message from Fed chairman Powell in Jackson Hole last week. His intervention was all about stars: "At the Fed and elsewhere, analysts talk about these values so often that they have acquired shorthand names... u^* (pronounced "u star") is the natural rate of unemployment, r^* ("r star") is the neutral real rate of interest, and π^* ("pi star") is the inflation objective. According to the conventional thinking, policymakers should navigate by these stars. In that sense, they are very much akin to celestial stars."

This makes sense were it not that estimates of the natural rate of employment and the neutral interest rate are highly uncertain. Interestingly, this issue had already been covered at Jackson Hole back in 2003. Though the analytical sophistication has increased, the challenge of determining the exact location of the stars remains huge. The wide range of estimates of the neutral rate of interest limits its relevance for decision making, including for investors. Potential growth (and hence output gap) estimates vary significantly depending on the source and are subject to considerable revisions. This is less of an issue with 'pi star' because the inflation objective is chosen. However, as emphasized by Powell "in the run-up to the past two recessions, destabilizing excesses appeared mainly in financial markets rather than in inflation." So when inflation expectations are well anchored, the focus should shift from inflation to other signs of overheating (although this didn't yet show up in Fed communication).

Financial markets considered Powell's speech as rather dovish and there are several reasons for that. The chairman's praise for the Fed's gradualism under Greenspan suggests he's very much inspired by this approach:

.../...



Source: IMF, OECD, CBO, BNP Paribas

p. 3

Markets Overview

p. 4

Pulse & Calendar

p. 5

Economic scenario

Eco
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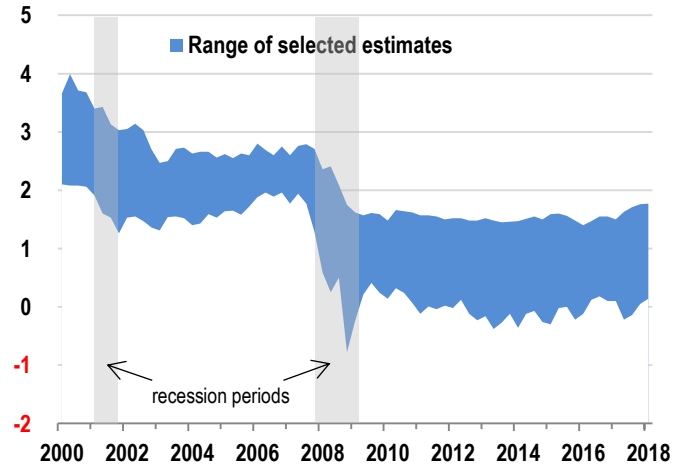
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"The FOMC thus avoided... overemphasizing imprecise estimates of the stars. Under Chairman Greenspan's leadership, the Committee converged on a risk-management strategy that can be distilled into a simple request: Let's wait one more meeting; if there are clearer signs of inflation, we will commence tightening".

Moreover, ever better anchored inflation expectations implied "a smaller risk that an inflation uptick under Greenspan's "wait and see" approach would become a significant problem", a phrase which is reminiscent of the recent emphasis on the symmetric nature of the Fed's inflation objective. To avoid any doubt, Powell then adds: "Given what the economy has shown us over the past 15 years, the need for the sort of risk-management approach that originated in the new-economy era is clearer than ever before." In plain English, the Fed's approach can be described as gradual, cautious, data-dependent and pragmatic. The description of the current environment also brings a dovish bias: "inflation has become much less responsive to changes in resource utilization... While inflation has recently moved up near 2 percent, we have seen no clear sign of an acceleration above 2 percent, and there does not seem to be an elevated risk of overheating." Finally the warning that "I am confident that the FOMC would resolutely "do whatever it takes" should inflation expectations drift materially up or down" didn't impress markets. Investors seem as confident as the Fed that inflation will remain well-behaved.

William De Vijlder

RANGE OF SELECTED ESTIMATES FOR THE NEUTRAL FED FUND RATE



Source: Federal Reserve, BNP Paribas



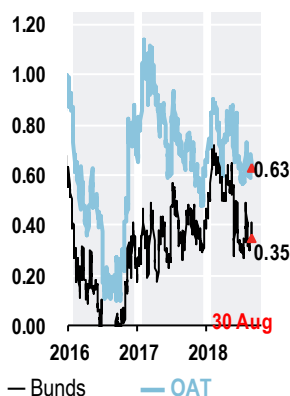
Markets overview

The essentials

Week 24-8 18 > 30-8-18

↗ CAC 40	5 433	↗ 5 478	+0.8 %
↗ S&P 500	2 875	↗ 2 901	+0.9 %
↗ Volatility (VIX)	12.0	↗ 13.5	+1.5 pb
↗ Euribor 3M (%)	-0.32	↗ -0.32	+0.0 bp
↘ Libor \$ 3M (%)	2.32	↘ 2.31	-0.5 bp
↗ OAT 10y (%)	0.62	↗ 0.63	+1.1 bp
↗ Bund 10y (%)	0.35	↗ 0.35	+0.2 bp
↗ US Tr. 10y (%)	2.83	↗ 2.87	+3.4 bp
↗ Euro vs dollar	1.16	↗ 1.17	+0.3 %
↘ Gold (ounce, \$)	1 207	↘ 1 201	-0.6 %
↗ Oil (Brent, \$)	76.2	↗ 77.5	+1.7 %

10 y bond yield, OAT vs Bund



Euro-dollar



CAC 40



Money & Bond Markets

Interest Rates		highest' 18	lowest' 18	
€ ECB	0.00	0.00 at 01/01	0.00 at 01/01	
Eonia	-0.36	-0.35 at 01/01	-0.37 at 18/05	
Euribor 3M	-0.32	-0.32 at 30/07	-0.33 at 01/01	
Euribor 12M	-0.17	-0.17 at 29/08	-0.19 at 19/02	
\$ FED	2.00	2.00 at 14/06	1.50 at 01/01	
Libor 3M	2.31	2.37 at 04/05	1.69 at 01/01	
Libor 12M	2.83	2.83 at 29/08	2.11 at 01/01	
£ BoE	0.75	0.75 at 02/08	0.50 at 01/01	
Libor 3M	0.80	0.81 at 06/08	0.52 at 04/01	
Libor 12M	1.05	1.06 at 02/08	0.76 at 03/01	

At 30-8-18

Yield (%)		highest' 18	lowest' 18	
€ AVG 5-7y	0.76	0.90 at 08/06	0.41 at 18/04	
Bund 2y	-0.62	-0.55 at 01/08	-0.79 at 29/05	
Bund 10y	0.35	0.72 at 15/02	0.27 at 19/07	
OAT 10y	0.63	0.91 at 08/02	0.57 at 13/07	
Corp. BBB	1.64	1.67 at 11/06	1.17 at 08/01	
\$ Treas. 2y	2.65	2.68 at 26/07	1.89 at 01/01	
Treas. 10y	2.87	3.13 at 17/05	2.41 at 01/01	
Corp. BBB	4.29	4.42 at 17/05	3.59 at 01/01	
£ Treas. 2y	0.69	0.85 at 21/03	0.40 at 01/01	
Treas. 10y	1.36	1.67 at 15/02	1.23 at 01/01	

At 30-8-18

10y bond yield & spreads

4.78%	Greece	442 pb
3.20%	Italy	285 pb
1.91%	Portugal	156 pb
1.41%	Spain	106 pb
0.71%	Belgium	36 pb
0.63%	France	28 pb
0.60%	Austria	24 pb
0.57%	Ireland	22 pb
0.53%	Finland	18 pb
0.47%	Netherlands	12 pb
0.35%	Germany	

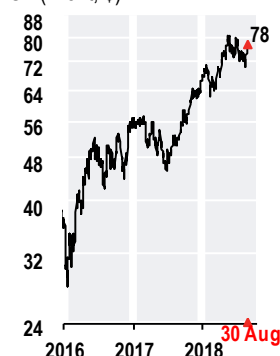
Commodities

Spot price in dollars		lowest' 18	2018(€)	
Oil, Brent	77.5	62.2 at 13/02	+19.8%	
Gold (ounce)	1 201	1 179 at 17/08	-5.1%	
Metals, LMEX	2 989	2 820 at 15/08	-10.0%	
Copper (ton)	6 063	5 759 at 15/08	-13.4%	
CRB Foods	316	316 at 30/08	-3.2%	
wheat (ton)	182	155 at 16/01	+18.0%	
Corn (ton)	119	119 at 29/08	-3.4%	

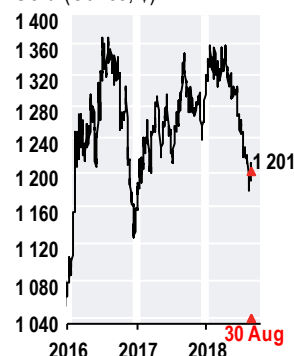
At 30-8-18

Variations

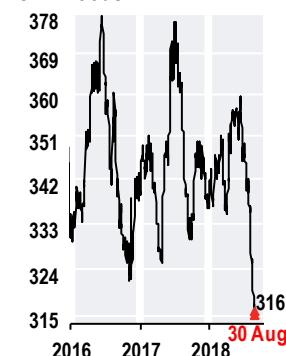
Oil (Brent, \$)



Gold (Ounce, \$)



CRB Foods



Exchange Rates

1€ =		highest' 18	lowest' 18	2018	
USD	1.17	1.25 at 25/01	1.13 at 15/08	-2.9%	
GBP	0.90	0.91 at 28/08	0.86 at 17/04	+1.0%	
CHF	1.13	1.20 at 19/04	1.12 at 15/08	-3.3%	
JPY	129.82	137.29 at 02/02	124.96 at 15/08	-4.0%	
AUD	1.60	1.61 at 26/03	1.53 at 09/01	+4.2%	
CNY	7.97	8.00 at 24/08	7.42 at 29/05	+1.9%	
BRL	4.88	4.88 at 30/08	3.87 at 08/01	+22.4%	
RUB	79.64	79.93 at 29/08	68.06 at 09/01	+15.2%	
INR	82.52	82.53 at 29/08	75.92 at 08/01	+7.7%	

At 30-8-18

Variations

Equity indices

Index		highest' 18	lowest' 18	2018	2018(€)
CAC 40	5 478	5 640 at 22/05	5 066 at 26/03	+3.1%	+3.1%
S&P500	2 901	2 914 at 29/08	2 581 at 08/02	+8.5%	+11.8%
DAX	12 494	13 560 at 23/01	11 787 at 26/03	-3.3%	-3.3%
Nikkei	22 870	24 124 at 23/01	20 618 at 23/03	+0.5%	+4.7%
China*	81	101 at 26/01	77 at 16/08	-8.1%	-5.7%
India*	601	642 at 29/01	547 at 23/05	+9.1%	+1.3%
Brazil*	1 589	2 393 at 26/01	1 589 at 30/08	-1.0%	-19.1%
Russia*	569	707 at 26/02	551 at 23/08	+9.2%	-3.0%

At 30-8-18

Variations

* MSCI index



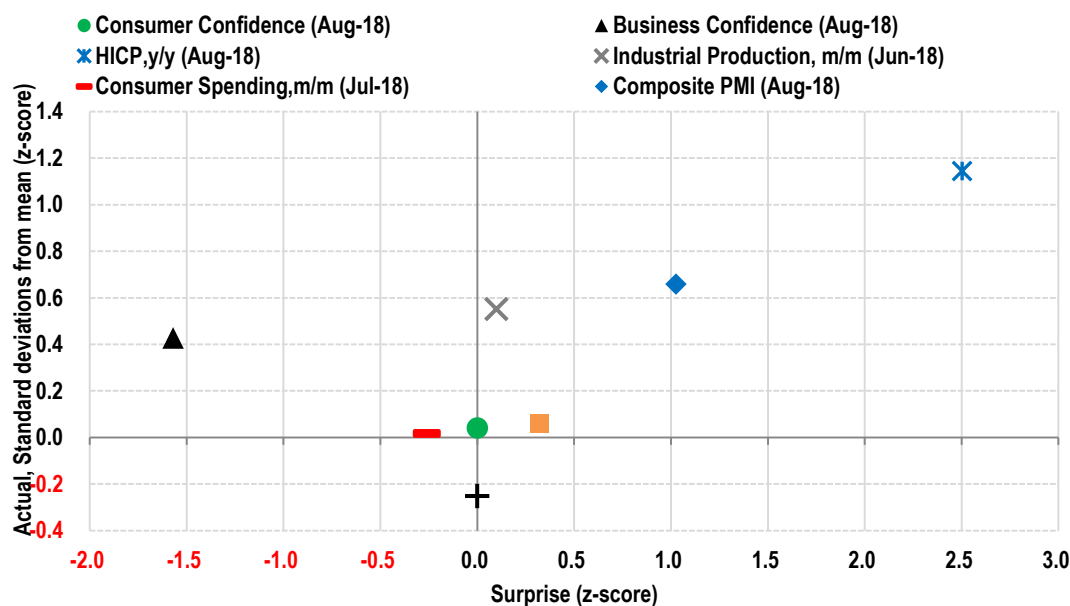
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Pulse

France: A still mixed dataflow over the summer

After a first half marked by a sharp slowdown in growth, signs of the expected acceleration are still tentative. According to the INSEE composite index, business confidence continued to deteriorate slightly in July and August, a negative signal offset by the slight improvement in the Markit composite PMI. Consumer confidence stopped declining but it has still not resumed rising. Consumer spending on goods rose very modestly in July but they display a significantly positive carry-over. The unemployment rate is a lagging indicator but its 0.1 point decline in Q2 is good news nonetheless, as well as the inflation stabilization in August.



Source: Bloomberg, Markit, BNP Paribas

Indicators preview

As usual a busy week at the start of a new month with Markit PMI indicators (manufacturing, services and composite) in several countries, as well as the ISM manufacturing and non-manufacturing indices in the US. The highlight of the week are of course the US labour market data.

Date	Country/Region	Event	Period	Prior
09/03/2018	France	Markit France Manufacturing PMI	August	--
09/03/2018	Eurozone	Markit Eurozone Manufacturing PMI	August	--
09/04/2018	United States	ISM Manufacturing	August	58.1
09/05/2018	France	Markit France Composite PMI	August	--
09/05/2018	Eurozone	Markit Eurozone Composite PMI	August	--
09/06/2018	United States	ISM Non-Manufacturing Composite	August	55.7
09/06/2018	United States	Durable Goods Orders	July	--
09/07/2018	France	Trade Balance	July	-6.248e+09
09/07/2018	United Kingdom	Halifax House Prices MoM	August	1.4%
09/07/2018	Eurozone	GDP SA QoQ	2Q	--
09/07/2018	United States	Change in Nonfarm Payrolls	August	157000
09/07/2018	United States	Unemployment Rate	August	3.9%

Source: Bloomberg, BNP Paribas



Economic scenario

UNITED STATES

■ Despite slow start, economy is expected to expand at a 3% or so in 2018, thanks to tax cuts, booming profits and credit. However, the current weakening in external trade indexes put the risk on the downside.

■ Inflation is accelerating in the wake of higher oil prices and more evident tensions in the labour market.

■ The Fed will keep on normalizing monetary conditions. We forecast the Fed Funds target rate to reach 2.75% by early

CHINA

■ Economic growth will decelerate in 2018. Despite the slowdown, the central bank will have to continue to act to encourage the deleveraging of financial institutions and corporates and reduce financial instability risks. Fiscal policy should remain expansionist.

■ The outlook for exports and household spending is rather favourable in the short term, but the tightening of domestic credit conditions, restructuring measures in the industry and less buoyant property market will weigh on economic activity.

EUROZONE

■ The recovery is continuing, although it has been weaker than expected at the start of the year. Intra-EU trade builds with domestic demand, especially corporate investment.

■ Inflation has rebounded in the wake of higher oil prices, but the core CPI trend remains subdued. Along with renewed tensions over sovereign debt spreads (Italy) this argues for the ECB to keep on buying until year end at least, and to maintain the status quo on key rates thereafter (first hike seen in Q4'19).

FRANCE

■ Growth remains robust but gets back down to a less rapid pace than in 2017. Households' consumption is supported by the jobs recovery but restrained by the upturn in inflation. Investment and exports dynamics remain favourable. Risks are on the downside. A slight rise in core inflation is appearing but remains to be confirmed.

INTEREST RATES AND FX RATES

■ In the US, ongoing strong growth and a very low unemployment rate pave the way for several rate hikes (we expect 4 this year and 1 next). This will put upward pressure on bond yields in 2018. The ECB is expected to stop its QE programme at the end of 2018 and to hike its rates by the middle of 2019. As a consequence, bond yields should follow a rising trend, including in 2019. No change expected in Japan

■ The narrowing bond yield differential between the US and the eurozone should cause a strengthening of the euro, all the more so considering it is still below its long-term fair value (around 1.34).

SUMMARY

%	GDP Growth			Inflation		
	2017	2018 e	2019 e	2017	2018 e	2019 e
Advanced	2.3	2.3	1.5	1.8	2.1	1.9
United-States	2.3	2.9	1.8	2.1	2.5	2.1
Japan	1.7	0.9	0.5	0.5	0.9	0.9
United-Kingdom	1.7	1.4	1.3	2.7	2.8	2.2
Euro Area	2.6	2.2	1.5	1.5	1.8	1.8
Germany	2.5	2.0	1.6	1.7	1.9	2.0
France	2.3	2.0	1.8	1.2	2.0	1.6
Italy	1.6	1.3	1.0	1.3	1.4	1.7
Spain	3.1	2.8	2.0	2.0	1.7	1.7
Netherlands	3.2	2.3	1.7	1.3	1.7	1.8
Emerging	5.9	5.9	5.8	2.4	3.1	3.2
China	6.9	6.4	6.0	1.6	2.3	2.5
India	6.7	7.4	7.6	3.6	4.5	4.4
Brazil	1.0	2.0	3.5	3.4	3.7	3.8
Russia	1.5	1.8	1.6	3.7	3.5	4.4

Source : BNP Paribas Group Economic Research (e: Estimates & forecasts)

INTEREST RATES & FX RATES

Interest rates, %		2018				2017	2018e	2019e
End of period		Q1	Q2	Q3e	Q4e			
US	Fed Funds	1.75	2.00	2.25	2.50	1.50	2.50	2.75
	Libor 3m \$	2.31	2.34	2.50	2.65	1.69	2.65	2.55
	T-Notes 10y	2.75	2.86	3.20	3.25	2.41	3.25	3.00
Ezone	ECB Refi	0.00	0.00	0.00	0.00	0.00	0.00	0.25
	Euribor 3m	-0.33	-0.32	-0.33	-0.33	-0.33	-0.33	0.07
	Bund 10y	0.50	0.31	0.90	1.10	0.42	1.10	1.50
	OAT 10y	0.60	0.62	1.15	1.35	0.66	1.35	1.75
UK	Base rate	0.50	0.50	0.75	0.75	0.50	0.75	1.25
	Gilt 10y	1.39	1.33	1.60	1.75	1.23	1.75	2.10
Japan	BoJ Rate	-0.07	-0.07	-0.10	-0.10	-0.04	-0.10	-0.10
	JGB 10y	0.04	0.03	0.05	0.05	0.05	0.05	0.00

Exchange Rates		2018				2017	2018e	2019e
End of period		Q1	Q2	Q3e	Q4e			
USD	EUR / USD	1.23	1.17	1.15	1.24	1.20	1.24	1.34
	USD / JPY	106	111	107	104	113	104	98
	GBP / USD	1.40	1.32	1.29	1.41	1.35	1.41	1.52
	USD / CHF	0.96	0.99	1.03	0.97	0.97	0.97	0.93
EUR	EUR / GBP	0.88	0.88	0.89	0.88	0.89	0.88	0.88
	EUR / CHF	1.18	1.16	1.19	1.20	1.17	1.20	1.25
	EUR / JPY	131	129	123	129	135	129	131

Source: GlobalMarkets BNP Paribas (e: estimates & forecasts)



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