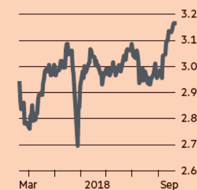
Analysis. Capital markets

Investors buckle up for longer Fed tightening cycle

This week's expected rise by the Fed will be the third this year Chris Wattie/Reuters

Interest rate derivatives show markets poised for rate tightening

Yield of three-month Eurodollar contract maturing in Dec 2019 (%)



US government bond yields climb to near seven-year high

10-year US Treasury yield (%)

Sources: Bloomberg

Central bank is set to lift rates tomorrow as further moves start to look increasingly likely

ROBIN WIGGLESWORTH AND JOE RENNISON — NEW YORK

Treasury bears were forced back into hibernation earlier this year, as US government bond yields remained stubbornly subdued despite faster growth and firmer inflation. But the Federal Reserve is beginning to reawaken the slumbering pessimists as investors prepare for a more active tightening cycle.

The US central bank is set to raise rates for a third time this year tomorrow, with another increase in December widely expected. But investors are also beginning to gird themselves for the possibility that Fed policymakers will not sit still in 2019 either, as many had until recently expected. And that reappraisal has rattled the market.

"The story of a 2019 Fed pause has gotten banged up," said Edward Al-Hussainy, a senior strategist at Columbia Threadneedle. "There now seems to be far more market confidence that the Fed will continue to hike."

This month the 10-year Treasury yield rose cleanly above the 3 per cent mark for the first time since May, and at 3.07 per cent it is currently within a whisker of hitting a new seven-year high. The 30-year Treasury yield, known as the long bond, has also climbed sharply this month, to a four-month high of 3.22 per cent.

Should the 10-year and 30-year Treasury yields both close above 3 per cent and 3.25 per cent, it will signal a "game changer" for markets, according to Jeffrey Gundlach, the head of DoubleLine Capital, a big bond investor.

Unlike previous moves in Treasury yields this year, which were primarily fuelled by rising inflation expectations, the recent jump appears mostly driven by a reappraisal of how aggressively the US central bank will tighten monetary policy in the coming year.

The five-year "break-even" rate, a measure of inflation expectations derived from comparing nominal and inflation-protected Treasury bond yields, has nudged higher over the past week, but still remains below its 2018 average. Meanwhile, the yield of the Eurodollar futures contract for December 2019 — a derivative that allow traders to bet on where interest rates are heading — has jumped to a four-year high of 3.15 per cent.

The primary catalyst for the reappraisal was better than expected growth in average hourly earnings in August, but also the notably hawkish comments by several Federal Reserve policymakers that have normally been considered in the dovish camp. Even Lael Brainard, a particularly dovish Fed governor, earlier this month said that more rate increases were warranted given the economic stimulus provided by the Trump administration's tax cuts.

"I think that wage growth was a wake-up call for a lot of people but it was a series of events that set the market on its ear," said Bill O'Donnell, a rate strategist at Citi. "It's that second phase, of doves turning to hawks and talking about restrictive policy, that has the market repricing 2019 hikes."

The upcoming Federal Open Market Committee meeting could further rattle the market. The Fed is not expected to meaningfully change its forecasts at the meeting, but the expected rate increase would lift the Fed funds rate — the central bank's main monetary policy target — above the Fed's preferred inflation measure for the first time since 2008.

In the event that Fed chair Jay Powell and the FOMC's predictions reinforce the view that the central bank is intent on raising rates at the planned pace, it could force an even more meaningful investor reassessment. In turn a renewed bout of dollar strength will restart the emerging market turbulence that has abated in recent weeks.

"The Fed doesn't need to raise its forecasts, they just need to stress their confidence," said Mr Hussainy. "If Treasuries then sell off and the dollar rallies then we'll be talking about emerging market pain again."

> 'I think that wage growth was a wake-up call for a lot of people but it was a series of events that set the market on its ear'

However, some analysts and investors argue that a more hawkish central bank that tightens interest rates more aggressively should instead subdue longer-term bond yields, as it signals that the Fed is acting preemptively to slow growth and forestall inflation. But instead of flattening the "yield curve" — the difference between short and long-term bond yields — the curve has instead steepened sharply this month. Typically, a steeper curve signals stronger growth expectations that risk spurring rising inflation pressures.

"The curve steepening and the belief that the Fed is going to continue to hike next year just doesn't jive," said Henry Peabody, a bond fund manager at Eaton Vance. "One of those two things has to adjust."

The explanation could be a broader investor reappraisal of whether the US economy is merely enjoying a temporary bout of strength, or finally finding another faster gear — as some Fed policymakers are now speculating, and might hint at the upcoming meeting.

And while many investors remain sceptical, Jim Caron, a bond fund manager at Morgan Stanley Investment Management, said "the market then has to at least price in the possibility of higher potential growth".

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Tail Risk

America's economic 'sugar high' has begun to wear off

COLBY SMITH

Last week the S&P 500 and Dow Jones Industrial Average both set all-time intraday peaks, but no binge ends well.

Whether from junk food or alcohol, initial euphoria eventually gives way to a crash, and often self-loathing. The same is true for too much stimulus.

Jacked up on tax cuts, a $1.3tn spending bill, easy monetary policy and a weakening dollar, Wall Street and the US economy have enjoyed their own version of a "sugar high", said JPMorgan. What's worse, the bank warned: the crash is coming.

Not quite yet, though.

At a recent conference, Charles Calomiris said that on a range of measures the US economy was doing well. Since the 2016 election, said the Columbia Business School professor, the stock market has gained nearly 40 per cent.

Median income, adjusted real wages and other indicators such as small business optimism and business investment have jumped higher too. Core capital goods orders have also shot up since the election, he added, and blue-collar jobs have increased at their fastest pace since 1984.

> The overall conclusion that the US economy has improved 'cannot be reasonably contested'

From a broad perspective, Professor Calomiris argued that the overall conclusion that the US economy has improved "cannot be reasonably contested".

Jason Furman, a Harvard professor who spoke at the same conference, concedes the same point. The US economy was growing faster than predicted, leading many analysts to revise up their 2018 real GDP forecasts.

But Professor Furman — like JPMorgan and a lot of other organisations — sees the sugar high wearing off soon. In the long run, growth is more or less unaffected by recent fiscal stimulus, he argued.

For JPMorgan, US economic and earnings growth are bound to decline not just because of higher interest rates and a stronger dollar, but also because of the continuing trade war, political tail risks in Washington and "the failure of the Fed to recognise those potential developments".

Get ready for the comedown. And maybe the self-loathing.

Brace for comedown: New York Stock Exchange this month

Equities

Fears for non-bank lenders take toll on India's Nifty

SIMON MUNDY — MUMBAI

Indian authorities are battling to contain growing fears of contagion from a big infrastructure lender struggling to service debts of $12.6bn, which has driven a sell-off of stocks in the country's huge non-bank financial sector.

The benchmark Nifty index declined 1.5 per cent yesterday for its fifth consecutive daily fall, with non-bank lenders among the biggest losers. The selling has reflected concerns about recent loan defaults by Infrastructure Leasing & Financial Services, one of the sector's biggest companies. In turn, the Nifty index has now dropped nearly 7 per cent from its record peak set late last month.

The retreat in the market was not halted by a co-ordinated attempt at reassurance from regulators.

In an unusual joint statement on Sunday evening, the Reserve Bank of India and the national securities regulator said they were "closely monitoring recent developments in financial markets and are ready to take appropriate actions, if necessary". Finance minister Arun Jaitley later promised that the government would take "all measures" to ensure non-bank lenders had adequate liquidity.

As the market opened yesterday, investors resumed selling their holdings of non-bank lenders, with high-profile groups Bajaj Finance, HDFC and Indiabulls Housing Finance falling more than 6 per cent. Banks have also been hit by selling, with the Nifty Bank index declining 8 per cent since the start of last week.

Unlisted IL&FS has played a big part in India's infrastructure boom over much of the past decade, raising billions of dollars from the corporate debt market to fund large-scale road, power and water projects. But along with other infrastructure groups, it has been hit by disappointing returns — in some cases, it says, because of delayed payments from government entities.

This month IL&FS group entities have announced a string of defaults, prompting fears about a squeeze in a small corporate debt market that has been a crucial funding source for non-bank lenders and where IL&FS has been one of the biggest borrowers. As of March IL&FS accounted for 3 per cent of outstanding loans in the Indian corporate debt market, as well as at least 0.5 per cent of bank loans, according to Moody's.

The central bank is 'closely monitoring' developments — Punit Paranjpe/AFP/Getty

The defaults have damaged trust in domestic rating agencies, which had assigned strong ratings to the group entities. Investors fear a vicious cycle in which nervous savers will withdraw money from fixed-income mutual funds, whose managers will be forced to sell holdings to meet redemption requests, thereby driving market weakness that will damage further the funding environment for non-bank lenders.

Ambit Capital had earlier warned that recent heavy flows into debt-focused mutual funds were causing non-bank lenders to grow used to unusually easy funding conditions in the debt market.

An indication of investors' tense nerves came on Friday when shares in Dewan Housing Finance Corporation fell 42 per cent on reports that a large investor had sold its short-term debt at a steep discount. Its shares rebounded 11 per cent yesterday after it gave reassurances on its liquidity.

The problems at IL&FS highlight the inherent risks of the model pursued by many Indian non-bank entities that had used short-term debt to fund long-term investments, noted analysts at Credit Suisse. "It is time to be cautious on [non-bank financials] that have grown asset-liability mismatches," they wrote.

Capital markets

Poland wins upgrade from EM status by FTSE Russell

JAMES SHOTTER — WARSAW
KATIE MARTIN — LONDON

Poland has been upgraded to "developed market" status in indices run by FTSE Russell, becoming the first country in the world to be promoted in almost a decade.

The move is the latest recognition of the speed and scale of the development of Poland's capital markets and overall economy, which has more than doubled in size since the country joined the EU in 2004, and is on the second-longest growth streak in the OECD, having not suffered a recession since the early 1990s.

Russell's move to rank Poland alongside the US, UK and Germany has been in the works for several months and involves shifting 37 companies including PKO Bank and Bank Pekao into the developed-market basket.

Poland was also upgraded by Stoxx, part of the Deutsche Boerse Group, last week. Helping it to straddle two investor bases, though, it remains in the emerging-market category for MSCI.

"The development . . . represents a fundamental change in the perception of Poland among global investors," said Marek Dietl, chief executive of the Warsaw Stock Exchange. "Poland's reclassification will spark the interest of new investors in Polish issuers and open enormous opportunities for the entire capital market."

Poland's WIG20 index was up 1 per cent at 2,280.60 in afternoon trading.

Poland is the first central European economy to be upgraded by FTSE Russell. However, in a reminder of its fractious politics — which worries some investors — its upgrade coincided with a move by the European Commission to take Warsaw to the European Court of Justice over a controversial judicial reform that officials in Brussels says undermines the rule of law.

"One surprise is the timing," said Ed Cole, a portfolio manager at Man Group. "Poland is institutionally a strong country, but it has been sliding back off that trajectory for some years and in some ways is going backwards." Still, the upgrade is a validation of an economy that has had a "phenomenal run" in recent years, he added.

Piotr Matys, an emerging-markets analyst at Rabobank in London, said that Poland's increasingly consumption-led economy could be storing up stresses without greater investment in the private sector.