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EXECUTIVE BRIEFINGS
POLITICS AND ECONOMY: US INTEREST RATES

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The silver lining

The markets were understandably hammered following the Brexit vote with collapsing equities and bond yields. Currencies wavered with the pound tumbling to a 30 year low. Others, including the euro and those of emerging markets, too, dropped whilst the dollar and yen jumped proportionately. However, conditions have calmed somewhat, perhaps sooner than many may have expected. The main reason appears to have been indications from the United States Federal Reserve that a hike in interest rates would be deferred, at least for now.

Under Janet Yellen, its current head, the Fed has been cautious and justifiably so, seeking to avoid disruptions to what is essentially a fragile recovery in the US. Still, the markets had assumed, based on previous guidance, that rates were due for a 25 basis points hike this summer. The Fed's intensified dovishness more recently is chiefly on account of weaker than expected growth in labour markets in America. Over the course of 2015, the United States' economy added on average 200,000 new jobs each month. The national payroll consistently rose, as did wages, suggesting a level of robustness within the manufacturing and services sector. However, this trend reversed, rather abruptly, in April 2016 when job growth fell by as much as 50%. But it was really the May figures that stumped everyone when only 38,000 new jobs were created. Whilst these are early estimates, plausibly tarred by a strike in the telecom industry and subject to revision, the drift downwards is nonetheless perturbing. This could be, if generously argued, due to a natural correction in the labour market cycle, but it could also be on account of an underlying trend in declining investment. The Fed may have taken into consideration a material fall in inflation expectations. Central bankers want proof that jobs are being created and the basic momentum of the economy is intact. Adding to the Fed's woes was the startling Brexit vote and all the ambiguity it brings. The impact of this will take months to unfold.

Following Brexit, US equity futures plunged with investors scrambling after Treasury Bills. The benchmark 10-year note fell to 1.5% – a four year low, the dollar jumped 3% in a day and interest rate futures rallied hard. This makes a convincing case for the premise that a July hike is now pretty much off the table. Ms Yellen will conceivably opt for restraint. The reversal of the interest rate cycle over the past year has been deferred by crippling exports due to a strong dollar, muted inflation, low oil prices, weaker investment sentiment and distressing news from China. Ms Yellen is convinced that Brexit could further affect global financial conditions and more significantly, the US economic outlook. These are important for setting monetary policy. Ultimately, whether a hike takes place at all this year is consequent upon how bad things get. There are simply too many unknowns. Britain is, after all, the European Union's second biggest economy and its main military power.

A day after the vote, USD 2 trillion was wiped out of global fortunes. This risks a fall in consumer confidence and the IMF cut its global growth and trade forecasts. The global contagion menace could spread via sentiment, financial markets and perhaps barriers to trade. Brexit's impact on the US economy may influence exports, pay roll expansion and economic growth equivalent to a 25 basis points hike in interest rates, as some analysts believe. Brexit is an ominous black cloud eclipsing the global economic system. A deferment of a rate hike is about as close to a silver lining as it gets. Small mercies!

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