



## Economics Weekly September 29, 2016

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## U.S. interest rate outlook in 2017

- Tightening pace of monetary policy in the U.S. is slower than expected
- The Fed has been managing market expectations on interest rate hikes to stabilize economic growth
- The Fed may raise interest rate by 50bp to 1% before 2018
- Unemployment rate will improve slightly in 2017-18 and rebound in 2019
- Inflation rate will approach the targeted 2% in 2018
- Rally of DJIA is likely to sustain in 2017 but market risk will peak in 2018-19

**End-2017 median Fed funds rate is at 1.1%, implying the Fed will raise rate by 50bp before 2018.** The Fed has been revising down the Fed funds rate projections for 2016-18 during the last three FOMC meetings in Mar/June/Sep. The Federal funds rate curve has been shifting downward, meaning that the frequency and range of rate hikes will be lower than expected. We believe the Fed is signaling that a low interest rate environment will sustain in the medium-to-short term after the supposed rate hikes in 2016-18. In our view, the Fed has been managing interest rate expectations to encourage corporate managers to increase investments and expand businesses so as to lend support to the underlying economy (Exhibit 1).

**Expected long-term Fed funds rate is slashed to below 3%, 78bp lower than the average rate in 1998-2007 (pre-QE period).** In the latest FOMC meeting in Sep, the Fed predicts the median Fed funds rate at end-2016 will be 0.6%, 0.8 ppt below the projection in Dec 2015. The median Fed funds rate at end-2017 and end-2018 will be 1.1% and 1.9%, 1.3 ppt and 1.4 ppt lower than the Dec projection. The long-term Fed funds rate is forecasted to be 2.9%, 0.6ppt lower than that in the Dec projection. Based on our estimates, the average Fed funds rate during 1998-2007 (pre-QE period) was 3.78% and the average Fed funds rate during 1998-9/2016 was 2.23%. Hence, the latest expected long-term Fed funds rate is lower than the average rate in the pre-QE period. In our view, the Fed could be signaling that the long-term Fed funds rate is unlikely to return to pre-QE level (Exhibits 2-3).

**Fed funds rate futures market suggests the market disagrees with the Fed.** On Sep 28, 2016, the Fed Funds futures market indicated a 53% chance of the Fed raising the Fed funds target rate by 25bp to 0.75% by Dec 2016; it also showed a 35% chance of the target rate being raised further by 25bp to 1.0% before end-2017. In general, the market is uncertain if the economy is strong enough to allow the Fed to increase rate further in 2017 after the rate hike in Dec 2016.

**Improvement in unemployment rate is expected in coming years will be marginal, suggesting effectiveness of monetary policy to stimulate the job market is decreasing.** The Fed predicts the average unemployment rate in 4Q16 to be 4.8% (vs. 4.9% in Aug 2016). Unemployment rate declined from 6.7% by Dec 2013 to 5.6% by Dec 2014 and 5.0% by Dec 2015. Reduction in unemployment rate has been narrowing in 2016. Although the Fed still expects



unemployment rate to fall slightly in 2017 to 4.6% and 2018 to 4.5%, the long-term unemployment rate will be 4.8%, higher than that in 2017-18. The Fed's long-term projection indicates unemployment rate will bottom out in 2018 and may rebound afterward (Exhibits 4-5).

**If the Fed is right, the rally of the U.S. stock market will persist in 2017.** A pattern has been identified when we track the historical trend of Dow Jones Industrial Average Index (DJIA Index) and unemployment rate: the Index would reach a cyclical peak after unemployment rate hits a cyclical bottom. As the Fed expects the next cyclical bottom for unemployment to occur in 2018, the DJIA Index is likely to reach its cyclical peak in 2018 (Exhibit 6).

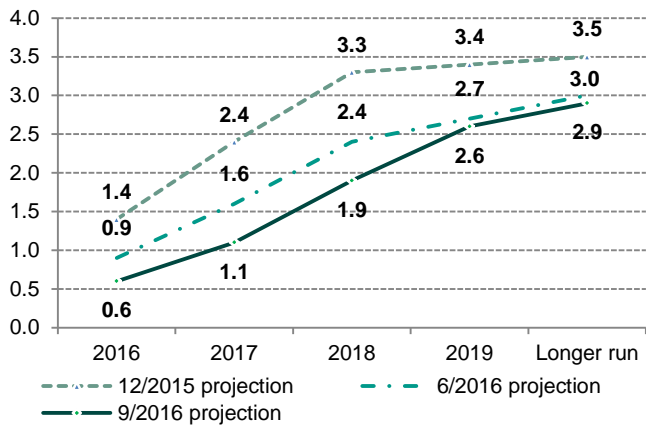
**Core PCE inflation will near the 2.0% target in 2018.** The Fed maintains the inflation forecasts for 2018 while revising down the ones for 2017. Core personal consumption expenditure inflation (Core PCE inflation, excluding food and fuel) is expected to reach 1.7% in 4Q16, as compared to 1.61% in June 2016. Core PCE inflation will inch up to 1.8%, 2.0% and 2.0% in 4Q17, 4Q18 and 4Q19, respectively. The Fed's projections suggest inflation will near the 2% target in 2018 and stabilize in 2019. In other words, the Fed is signaling that it will be in no rush to make substantial increase in the Fed funds rate in 2018-19 to contain inflation pressure (Exhibit 7).

**The Fed slashes economic growth projections for 2016-2017.** The Fed expects employment market to undergo marginal improvement in 2016 and 2017. GDP growth in 4Q16 is forecasted to be 1.8% YoY in the Sep projection, down 0.6ppt from the Dec projection. Expected GDP growth in 4Q17 is slashed from 2.2% YoY to 2.0% YoY in the Sep projection. Long-term economic growth will be 1.8%, 0.2ppt lower than the Dec projection (Exhibits 8-9).

**Monetary policy will be tightened at a pace slower than expected in 2017, as inflation pressure is contained while decline in unemployment rate narrows.** Economic projections by the Fed suggests the U.S. economy will be subject to higher risks in 2018-19 as inflation rises to the targeted 2% and unemployment rate bottoms. In the long run, the U.S. will maintain an economic growth rate slightly lower than 2%.

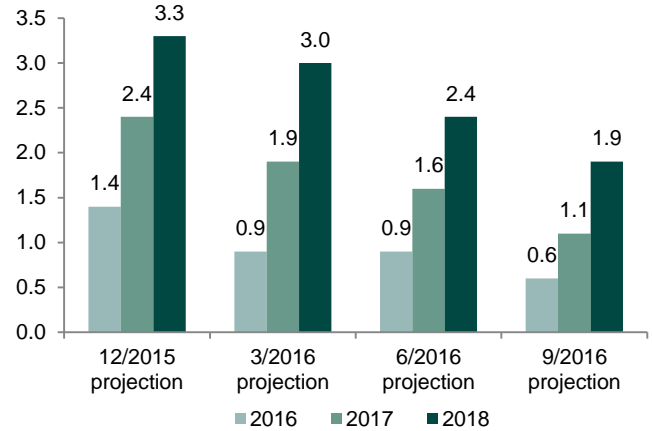


**Exhibit 1: Federal funds rate curves (at year-end), (%)**



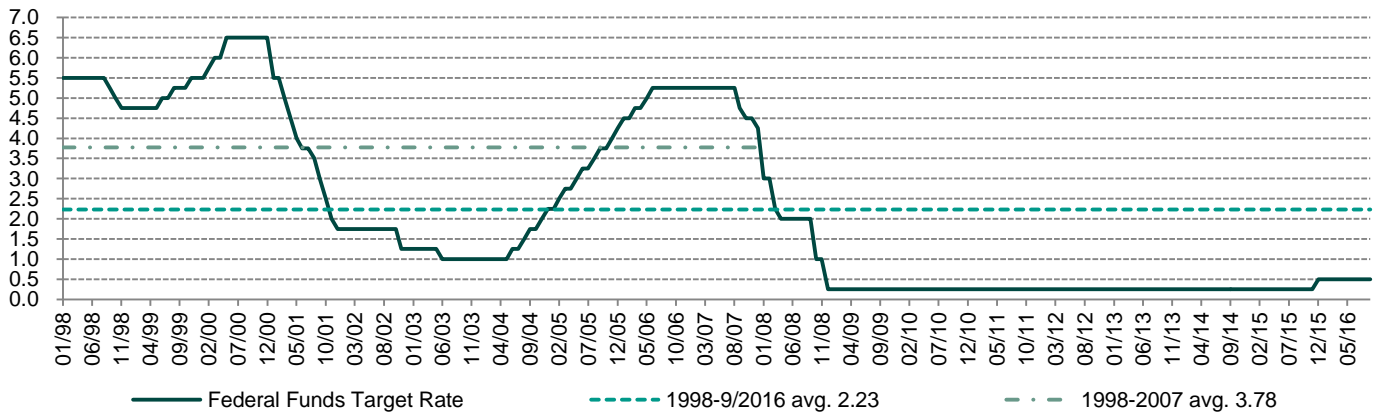
Source(s): Board of Governors of the Federal Reserve, ABCI Securities

**Exhibit 2: Federal funds rate outlook (at year-end), (%)**



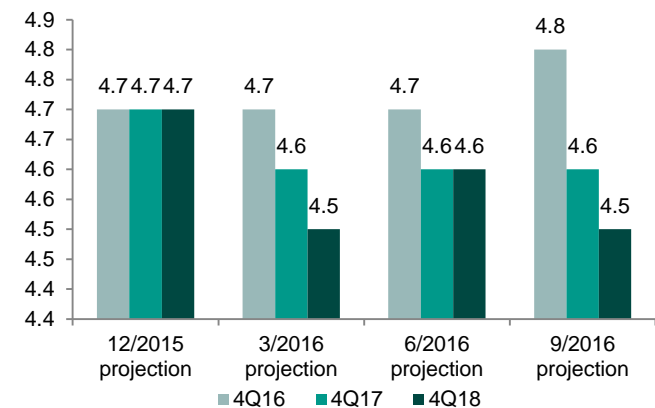
Source(s): Board of Governors of the Federal Reserve, ABCI Securities

**Exhibit 3: Federal funds target rate (1/1998- 9/2016; %)**



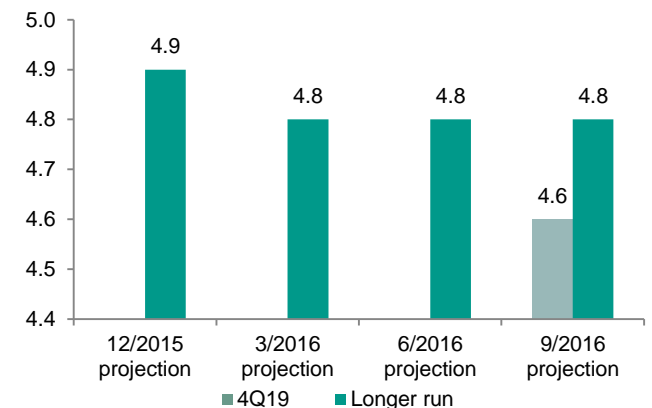
Source(s): Bloomberg, Federal Reserve, ABCI Securities

**Exhibit 4: Unemployment rate projections (average at 4Q of each year)**



Source(s): Board of Governors of the Federal Reserve, ABCI Securities

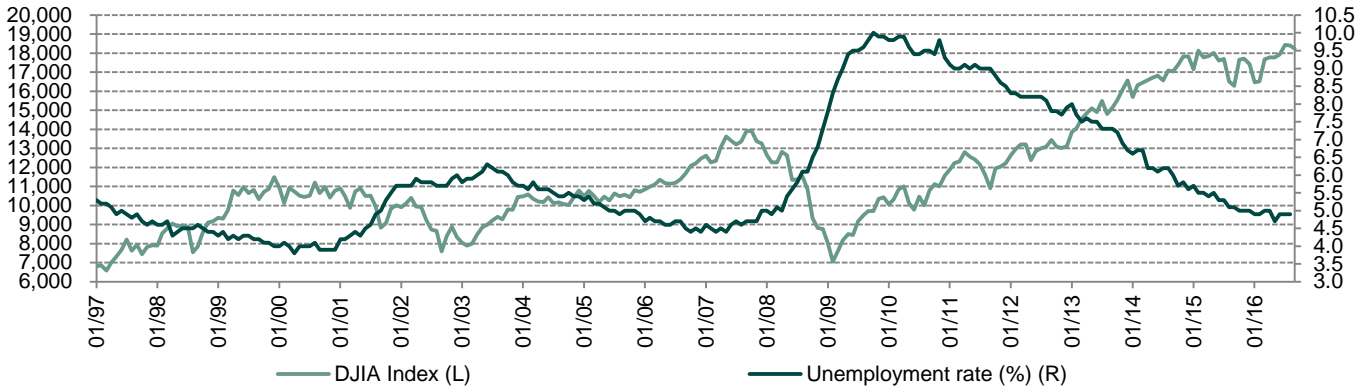
**Exhibit 5: Unemployment rate projections (average at 4Q of each year)**



Source(s): Board of Governors of the Federal Reserve, ABCI Securities

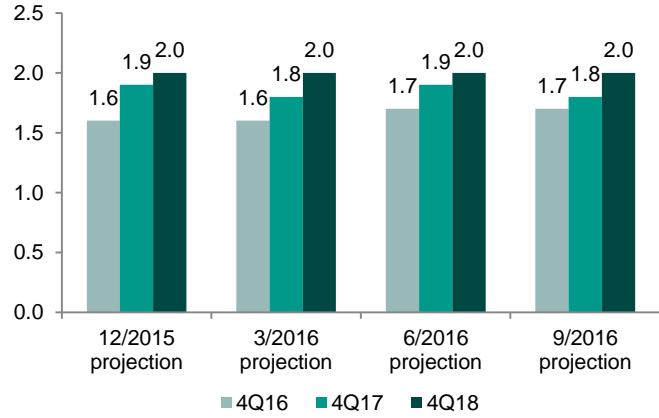


Exhibit 6: DJIA Index vs. unemployment rate (Index peaked after unemployment rate had bottomed)



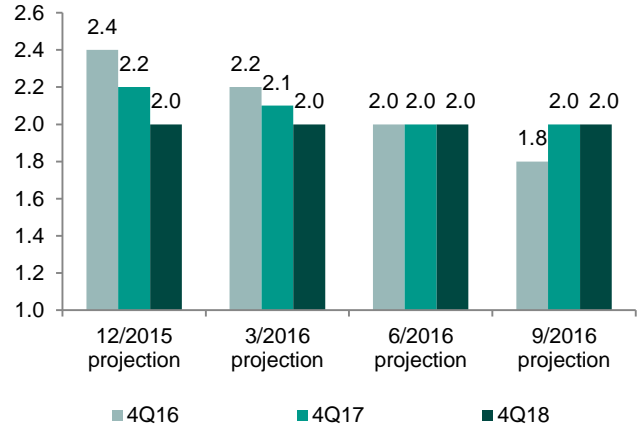
Source(s): Bloomberg, ABCI Securities

Exhibit 7: Core PCE inflation (ex. food & energy) (%YoY)



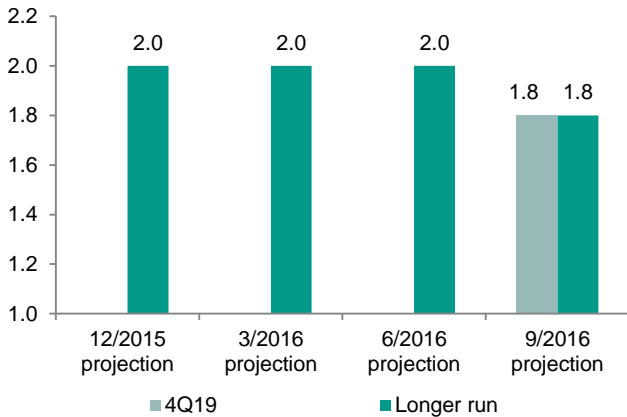
Source(s): Board of Governors of the Federal Reserve, ABCI Securities

Exhibit 8: GDP forecast (at 4Q each year) (%YoY)



Source(s): Board of Governors of the Federal Reserve, ABCI Securities

Exhibit 9: Long-term GDP forecasts (at 4Q each year) (%YoY)



Source(s): Board of Governors of the Federal Reserve, ABCI Securities



China Economic Indicators

	2015						2016							
	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug
Real GDP (YoY %)	---	---	6.9	---	---	6.8	---	---	6.7	---	---	6.7	---	---
Export Growth (YoY %)	(8.3)	(5.5)	(3.7)	(6.9)	(6.8)	(1.4)	(11.2)	(25.4)	11.5	(1.8)	(4.1)	(4.8)	(4.4)	(2.8)
Import Growth (YoY %)	(8.1)	(13.8)	(20.4)	(18.8)	(8.7)	(7.6)	(18.8)	(13.8)	(7.6)	(10.9)	(0.4)	(8.4)	(12.5)	1.5
Trade Balance (USD/bn)	43.0	60.2	60.3	61.6	54.1	60.9	63.3	32.6	29.9	45.56	49.98	48.11	52.31	52.05
Retail Sales Growth (YoY %)	10.5	10.8	10.9	11.0	11.2	11.1	10.2		10.5	10.1	10.0	10.6	10.2	10.6
Industrial Production (YoY %)	6.0	6.1	5.7	5.6	6.2	5.9	5.4		6.8	6.0	6.0	6.2	6.0	6.3
PMI - Manufacturing (%)	50.0	49.7	49.8	49.8	49.6	49.7	49.4	49.0	50.2	50.1	50.1	50.0	49.9	50.4
PMI - Non-manufacturing (%)	53.9	53.4	53.4	53.1	53.6	54.4	53.5	52.7	53.8	53.5	53.1	53.7	53.9	53.5
FAI (YTD) (YoY %)	11.2	10.9	10.3	10.2	10.2	10.0	10.2		10.7	10.5	9.6	9.0	8.1	8.1
CPI (YoY %)	1.6	2.0	1.6	1.3	1.5	1.6	1.8	2.3	2.3	2.3	2.0	1.9	1.8	1.3
PPI (YoY %)	(5.4)	(5.9)	(5.9)	(5.9)	(5.9)	(5.9)	(5.3)	(4.9)	(4.3)	(3.4)	(2.8)	(2.6)	(1.7)	(0.8)
M2 (YoY %)	13.3	13.3	13.1	13.5	13.7	13.3	14.0	13.3	13.4	12.8	11.8	11.8	10.2	11.4
New Lending (RMB/bn)	1,480	809.6	1,050	513.6	708.9	597.8	2,510	726.6	1,370	555.6	985.5	1380	463.6	948.7
Aggregate Financing (RMB bn)	742	1,082	1,300	476.7	1,020	1,815.1	3,425.3	824.5	2,404.0	751.0	659.9	1,629.3	487.9	1470.0

World Economic/Financial Indicators

Equity Indices				Global Commodities					Bond Yields & Key Rates		
	Closing price	Chg. WTD (%)	P/E	Unit	Price	Chg. WTD (%)	Vol (5-Day avg.)		Yield (%)	Chg. WTD (Bps)	
<b>U.S.</b>				<b>Energy</b>					US Fed Fund Rate		
DJIA	18,339.24	0.43	17.65	NYMEX WTI	USD/bbl.	47.08	5.85	676,830	0.50	0.00	
S&P 500	2,171.37	0.31	20.45	ICE Brent Oil	USD/bbl	48.62	5.95	247,037	3.50	0.00	
NASDAQ	5,318.55	0.24	41.86	NYMEX Natural Gas	USD/MMBtu	3.02	2.06	64,893	1.00	0.00	
MSCI US	2,070.84	0.30	21.10	China Qinhuangdao Port Thermal Coal <sup>2</sup>	CNY/Metric Tonne	552.00	1.10	N/A	0.1065	3.05	
<b>Europe</b>				<b>Basic Metals</b>					US Treasury (1 Yr)		
FTSE 100	6,849.38	(0.87)	57.57	LME Aluminum Cash	USD/MT	1,653.00	1.46	10,456	1.1427	(1.33)	
DAX	10,438.34	(1.78)	23.61	LME Aluminum	USD/MT	1,665.00	1.71	49,677	1.5823	(3.61)	
CAC40	4,432.45	(1.25)	22.65	CMX Copper Active	USD/lb.	4,808.00	(0.70)	7,210	0.00	0.00	
IBEX 35	8,740.40	(0.94)	21.66	LME Copper 3- mth Rolling Fwd.	USD/MT	4,818.00	(0.76)	41,330	0.5267	0.45	
FTSE MIB	16,222.21	(1.40)	37.30	<b>Precious Metals</b>					China 10-Yr Gov. Bond		
Stoxx 600	342.57	(0.80)	27.47	CMX Gold	USD/T. oz	1,328.10	(1.01)	147,938	2.7400	(0.20)	
MSCI UK	1,993.95	(0.88)	60.28	CMX Silver	USD/T. oz	19.32	(2.47)	58,478	0.00	0.00	
MSCI France	125.78	(1.26)	20.94	NYMEX Platinum	USD/T. oz	1,041.70	(1.81)	12,003	0.5267	0.45	
MSCI Germany	133.70	(1.55)	23.91	<b>Agricultural Products</b>					3 Month LIBOR		
MSCI Italy	45.90	(1.69)	38.03	CBOT Corn	USD/bu	330.75	(1.71)	135,417	0.8538	0.08	
<b>Asia</b>				CBOT Wheat	USD/bu	403.50	(0.31)	48,232	2.1880	2.12	
NIKKEI 225	16,699.18	(0.33)	20.79	NYB-ICE Sugar	USD/lb.	23.78	4.76	77,512	1-mth SHIBOR	2.7430	1.32
S&P/ASX 200	5,465.10	0.62	24.54	CBOT Soybeans	USD/bu.	953.50	(0.16)	120,333	3-mth HIBOR	0.5907	0.29
HSI	23,694.92	0.04	12.81						Corporate Bonds (Moody's)		
HSCEI	9,777.18	(0.19)	8.38						Aaa		
CSI300	3,250.39	(0.77)	14.98						Baa		
SSE Composite	3,003.40	(1.01)	17.44						3.39		
SZSE Component	10,527.50	(0.77)	31.98						(5.00)		
MSCI China	64.22	(0.77)	14.01						4.25		
MSCI Hong Kong	13,309.32	(0.05)	15.36						(5.00)		
MSCI Japan	800.05	(1.61)	16.91								

Note:

1. Data sources: Bloomberg, National Bureau of Statistics of China, ABCIS (updated on date of report)
2. The price is Coal 5500 kcal/kg FOB Spot Price

Currency

	Euro/USD	GBP/USD	AUD/USD	USD/JPY	USD/CHF	USD/CNY	USD/HKD	USD/CNY NDF 12-mth Spot pr.
Spot Rate	1.1228	1.3026	0.7695	101.33	0.9707	6.6704	7.7536	6.8310
Chg. WTD (%)	0.02	0.46	0.94	(0.31)	(0.03)	(0.02)	0.04	0.37



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### Definition of equity rating

Rating	Definition
Buy	Stock return $\geq$ Market return rate
Hold	Market return - 6% $\leq$ Stock return < Market return rate
Sell	Stock return < Market return - 6%

Stock return is defined as the expected % change of share price plus gross dividend yield over the next 12 months

Market return: 5-year average market return rate

Time horizon of share price target: 12-month

### Definition of share price risk

Rating	Definition
Very high	$2.6 \leq$ 180 day volatility/180 day benchmark index volatility
High	$1.5 \leq$ 180 day volatility/180 day benchmark index volatility < 2.6
Medium	$1.0 \leq$ 180 day volatility/180 day benchmark index volatility < 1.5
Low	180 day volatility/180 day benchmark index volatility < 1.0

We measure share price risk by its volatility relative to volatility of benchmark index. Benchmark index: Hang Seng Index.

Volatility is calculated from the standard deviation of day to day logarithmic historic price change. The 180-day price volatility equals the annualized standard deviation of the relative price change for the 180 most recent trading days closing price.

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