Deciphering Janet Yellen's message from Jackson Hole

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Key points

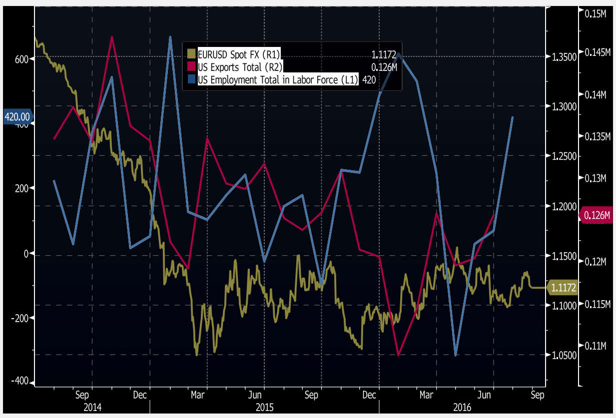
- Yellen's speech at Jackson Hole: What did she say and what did the market understand?
- The US interest rate message is more about the pace of hikes going forward rather than "when" will they occur.
- Can currency volatility provide an alternative means for achieving a respectable portfolio yield in a near-zero yield environment?

In a summer of sparse economic developments and news – post Brexit - the most awaited financial event came and passed by, without a splash. FED Chairman Yellen's speech in Jackson Hole was much anticipated. It was expected to give some clarity, some guidance and potentially some hope to the financial industry, investors and market participants on when, how and by how much should we expect Interest Rates to move in the near to medium term.

What we learned was more of the same: The FED feels good about data that shows solid growth in household spending plus improvements in the labour market, with unemployment at around 5% - which by US economic standards is considered close to full employment. In particular, economic growth has been slow but "sufficient" and has led to these improvements in the labour market.

On the other hand, the FED continues to cite the strengthening of the USD since mid-2014 as a reason for restrained foreign demand for US exports and services. Should the USD be weaker, increased demand for the latter could lead to further improvement in the growth prospects and continue to support the employment levels. (Please see the graph from Bloomberg for comparison).

With all of the above in mind, Yellen expects only moderate growth in real Gross Domestic Product (GDP), limited additional strengthening in the labour market and inflation rising to 2% over the next few years, with this 2% being the target rate for the FED.



	EUR/USD Spot FX (daily) - latest August 31st 2016	1.1172
	US Exports on Monthly basis (US Billion) - latest August 2016	126
	US Employment Net Monthly change (Thousands) - latest August 2016	420

Source: Bloomberg

Ok, so what now?

Knowing how to decipher the oracle of Delphi might help understand what change all of the above mean compared to what FED officials have been sharing with the public over the past 2 years. Fundamentally, the FED is no longer concerned so much with the actual timing of the next rate increase. It is more likely setting in concrete for all to come to terms with, that the path of the rate movements is its main concern: It will be ultra- gradual, it will be shallow and it will be sparse.

Given that there is an imminent US Presidential election in November, the FED –albeit independent from the government- would try not to stir the waters too much by raising rates just before an election. In fact, since 1990 when the FED began publicly announcing changes to its target rates, on no occasion has the FED raised its target rate in the two months prior to a presidential election. To do so would definitely increase the cost for every single person with a mortgage or borrowing in the US to begin with and hence alienate all voters. But what Yellen's speech has effected, is an increase in the probability of a rate increase in September from 22% to 42% and likewise for December from as low as 8% to 65%. At the moment economists are split over which one is more probable. However, Yellen's speech has simultaneously pushed back the probability of a further rate increase after that to the last quarter of 2017.

Talk about gradual, shallow and sparse…

But what would this interest rates path mean for the mighty USD? Interestingly enough, we now have some more clarity: On one hand, we see a slow yet clear upward trajectory for US rates. On the other hand, we see other major central banks such as the European Central Bank, the Bank of England, the Swiss National Bank and the Bank of Japan continuing on policies of lower interest rates, the exact opposite of the FED. This can prove beneficial for the USD: it may not continue strengthening at the same rapid and rampant pace as it has done in the last two years, but it does have the propensity based on the interest rates outlook to strengthen further. It will not be a one way trade, the road will be bumpy, meaning the USD can trend within a range for quite some time, yet this range will continue to be shifting in its favour over time, with the USD trading closer to the highest end of the range.

Quest for yield; is FX volatility the answer?

Over the last few years, investors have been desperate to generate yield in an ultra-low interest rate environment. The flat interest rate curve, combined with historically high asset valuations and the prolonged uncertainty regarding any signs of an economic recovery, have pushed investors away from tying up their liquidity in investments for long periods of time.

Hence, investors have taken the path of going for riskier, lower credit investments, or have paid expensively to get into better credit assets that do not yield much. Alternatively, people have been exploring the potential of short dated investments in markets where from time to time pockets of value emerge.

One such opportunity that we have observed is in the currency markets. Investment structures that use FX as an underlying benchmark benefit from higher volatility compared to other asset classes, which can help yield higher returns in short tenors, always taking into account the relevant risks. It helps that with more than USD 5.3 trillion traded daily, FX is by far the most liquid and largest asset class, so entry and exit is guaranteed and unrestricted.

And with the clear indication by Yellen at Jackson Hole in front of the World's Central Bankers that Rates are going to remain low for a very, very long time, it once again means market participants will be more hard pressed than ever to look for pockets of potential yield. The solid growth and drive we have seen in the currency markets in the last few years may just be the answer to this quest.

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