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FOCUS NOTES

Hawkish April FOMC minutes put a June rate hike on the table

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- The minutes of the April 26-27 FOMC meeting revealed a relatively hawkish tone. Most FOMC participants judged that an interest rate hike in June would be appropriate "if incoming data were consistent with economic growth picking up in the second quarter, labor market conditions continuing to strengthen, and inflation making progress toward the Committee's 2% objective."

- Although the April employment report was weaker-than-expected (nonfarm payrolls: +160k vs consensus expectations for a rise of 200k), April activity indicators are indeed consistent with an acceleration of real GDP growth in Q2. Industrial production grew by a solid 0.7%MoM in April, housing starts were up 0.6%, largely reversing the prior month's 9.0% drop, while inflation continued to grind higher with the headline CPI reporting the largest monthly increase since February 2013 (+0.4%MoM). The key question is whether the last round of economic data is enough to convince the more cautious FOMC members (including Chair Yellen and Vice Chair Dudley), as according to the minutes, "several participants were concerned that the incoming information might not provide sufficiently clear signals to determine by mid-June whether an increase in the target range for the federal funds rate would be warranted." These members would likely want to see additional economic releases to confirm that the growth acceleration is sustainable.

- As far as the FOMC's outlook of the US economy is concerned, the minutes acknowledged that GDP downturn in Q1 (the advance estimate of Q1 GDP and April employment report were not yet available at the time of the April FOMC meeting), but highlighted that it could partly reflect seasonal measurement problems. Most participants reported that labor market conditions have steadily improved, while many argued that they have reached or are close to the Committee's maximum employment objective. Meanwhile, recent hawkish comments by several regional Fed presidents, including Robert Kaplan, William Dudley, John Williams and Dennis Lockart, suggest that the committee may consider the recent softening in April payroll growth as temporary. With regards to inflation, views remained somewhat divided, with some participants waiting a gradual pickup to 2.0% objective, while others considered the recent firming in core CPI as broadly based and unlikely to unwind.

- The hawkish Fed minutes triggered another leg higher in the USD across the board on Thursday, with major equity markets in the red and US Treasury yields trending higher. Short-dated US notes underperformed, with the 2-yr yield hitting a session high of 0.912% earlier today, the highest in two months, and the 2/10-yr yield curve steepening slightly. Capitalizing on higher US Treasury yields, the DXY index hit a seven-week peak of 95.333 earlier today, recording cumulative gains of 0.8% so far this week. The USD/JPY was hovering around 110.00 at the time of writing, within distance from a three-week high of 110.38 recorded in Asia trade, while the EUR/USD plunged to a five-week low of 1.1206.

- Along these lines, we look for up to two interest rate hikes in 2016. Following the positive streak of economic releases for Q2 and the hawkish tone of the Fed minutes, a June rate hike remains a real possibility. Nevertheless, we do not exclude a delay for an interest rate hike in July or September, when the June 23 UK referendum will have passed (and assuming that the UK remains in the EU). Fed Funds Futures contracts currently assign a 32% chance of a Fed interest-rate increase in June, compared to around 20% ahead of the release of the FOMC minutes and c. 4% earlier this month. The May payroll report to be released on June 3 will provide the final gauge for the US labor market strength ahead of the 14-15 FOMC meeting, while all eyes will be on Chair Yellen's June 6 speech, which will likely give a hint for the short-term interest rate path.

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