

COULD THE FED SURPRISE IN SEPTEMBER? MARC CHANDLER BELIEVES SO

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I recently had a conversation with Professor Jeremy Siegel and Marc Chandler, Global Head of Currency Strategy at Brown Brothers Harriman, on the outlook for Federal Reserve (Fed) policy following the Jackson Hole Fed conference speeches. Professor Siegel reiterated his view that the Fed is likely to defer a September increase in its target rate and set the stage for a December [hike](#). Marc Chandler disagrees and thinks September has a much greater chance than the market gives credit to. I highlight Marc's views on the Fed and currency markets below. **Marc, what was your takeaway from Fed chair Janet Yellen's comments? Marc Chandler:** In following the U.S. Federal Reserve, I put emphasis on three people and only three people: Janet Yellen, Stan Fischer and Bill Dudley. Their messages have been consistent: The U.S. economy is doing better in the second half of the year (the gross domestic product [GDP] trackers are looking above 3%), the U.S. labor market continues to improve, and scares from poor employment reports in June, [Brexit](#), the Chinese [volatility](#)—all those things have passed. The Fed has been telling us they are more confident in their ability to raise [interest rates](#). But the market has been doubtful about the Fed hiking. The Fed has overpromised and underdelivered, in my view. I think the only way to reverse that is to underpromise and overdeliver. I thus think there is a reasonable chance of a September move. The Fed has given the market ample warning on conditions for a hike, and it needs to re-establish its credibility. It needs to demonstrate its resolve that when it says conditions warrant a hike, it backs it up with action. **What are the implications for the markets? Marc Chandler:** For equity investors, does a 25 [basis point \(bps\)](#) move in September or December make a difference? I don't think so. I think what is lifting the markets is [liquidity](#) driven from the European Central Bank (ECB) and the Bank of Japan (BOJ)—both of which may announce extensions of their programs in September. The BOJ is already buying all the [Japanese government bonds \(JGBs\)](#) the government is issuing, and it may expand that further. The ECB, after reviewing its policy in September, is likely to extend the duration of its purchases for another six months beyond March of next year. Of course, the Bank of England also resumed its [quantitative easing](#) program. Long-term investors have been chased out of the bond market with no [yields](#) and chased into higher-risk income or equities. **Marc, on the currency markets, in the past you have discussed a long-term target on the euro of 85 cents to the dollar. Is that still true? Marc Chandler:** I still believe before this cycle ends, the euro will sell off further, and I do still target the old lows of 82–85 cents back in 2000. The euro had a 35-cent move, from \$1.40 to \$1.05, and since then has been consolidating between \$1.08 and \$1.16 and in a band that is still wide enough for traders to lose a lot of money. With this type of broad sideways trading, investors should be asking whether this is a base (for a move higher) or a top (for a move lower). And I think this will prove more likely to be a top for the euro. The ECB is still easing while the Fed is tightening. Before the ECB is done easing, the Fed will tighten a few more times. Combining the health of the European banking system with the political environment and uncertainty from elections in Italy, France and Germany all point to a weaker euro. **The yen has been one of the strongest currencies this year. What is happening there? Marc Chandler:** Only in the last couple of months have I started putting a few explanations together for the counterintuitive yen strength. I have two big points: Thinking back to yen weakness, I now think that was driven more by diversification of Japanese pension funds into global assets than by Japan's monetary policies. Japanese pension funds sold JGBs and bought foreign bonds and stocks. Japanese companies kept more money offshore to get better yields. This all turned this year, and Japanese institutional investors were [unhedged](#). They were taking "naked" U.S. dollar currency exposures, and when the yen strengthened, they were forced to raise their dollar hedge ratios, sending the yen higher. **Note from Jeremy Schwartz:** A few days later, I traveled to Tokyo, and one of the largest Japanese insurance companies independently confirmed that it had been [unhedged](#) in [U.S. Treasuries](#) with U.S. dollar exposure in the past but earlier this year had turned to hedge more of its U.S. dollar risk (effectively buying

more yen through hedge instruments). Interestingly, this group was also turning to European bonds—because after factoring in the cost to hedge the euro, yields were better than U.S. yields (when factoring in the cost to hedge the U.S. dollar). The more Yellen hikes short-term rates, the more hedging costs rise and the less hedged these institutions will likely become, which could reverse some of the yen strength we've seen.

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DEFINITIONS

Rate Hike : refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

Brexit : an abbreviation of "British exit" that mirrors the term Grexit. It refers to the possibility that Britain will withdraw from the European Union.

Volatility : A measure of the dispersion of actual returns around a particular average level.

Interest rates : The rate at which interest is paid by a borrower for the use of money.

Basis point : 1/100th of 1 percent.

Liquidity : The degree to which an asset or security can be bought or sold in the market without affecting the asset's price. Liquidity is characterized by a high level of trading activity. Assets that can be easily bought or sold are known as liquid assets.

Japanese Government Bond (JGB) : A bond issued by the government of Japan. The government pays interest on the bond until the maturity date. At the maturity date, the full price of the bond is returned to the bondholder. Japanese government bonds play a key role in the financial securities market in Japan.

Quantitative Easing (QE) : A government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity.

Yield : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

Hedge : Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.

Unhedged : Strategy that includes the performance of both the underlying asset as well as the currency in which it is denominated. The performance of the currency can either help or hurt the total return experienced.

U.S. Treasury Bill : A short-term debt obligation backed by the U.S. government with a maturity of less than one year.