# Event Update - GCC Benchmark Interest Rate Hikes

December-2016

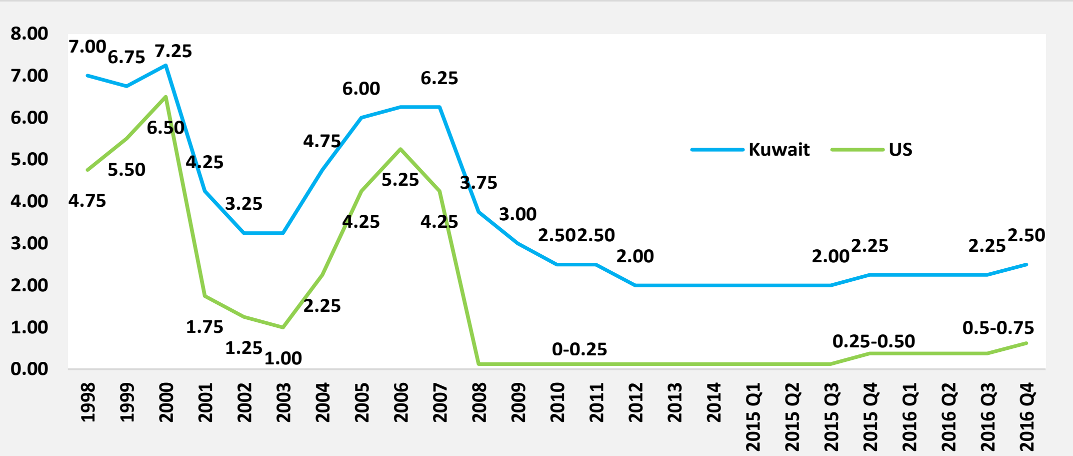
**US Fed hikes rate after one year; future normalization seen faster than envisaged in Sept-16:**
The Federal Reserve raised the fed funds rate for the first time in 2016, by 25bps on 14-December to a range of 0.50% - 0.75% from a range of 0.25% - 0.50%, as economic data and labor market conditions reportedly strengthened. The Fed updated their economic projections over 2016-19 and for the longer run, highlighting optimism by improving forecasts for real GDP, employment and inflation. Faster pace of rate hikes are expected in 2017 (3 hikes), as against September-16 expectations (2 hikes), but policy stance continued to remain accommodative.

**GCC states hike rates to keep currency peg, interbank rates rise:**
Following the announcement of a Fed rate hike, GCC states also raised their benchmark rates, given the pegs of their countries to the USD. Saudi Arabia raised its reverse repo rate to 0.75%, while keeping its repo rate at 2.0%. The Central Bank of Kuwait lifted its discount rate by 25bps from 2.25% to 2.5%, while the UAE raised rates on its certificates of deposits by 25 bps. Bahrain and Qatar also raised key interest rates by 25bps to 0.75%. The overnight interbank offered rates of UAE, Kuwait and Qatar rose as a result.

**Stronger USD, stabilizing oil prices seen; investors would prefer equities over fixed income:**
The USD continued to scale multi-year highs leading up to the Fed event, and even post the rate hike, a trend that is expected to continue in 2017, as more risk-off trades unfold. Meanwhile, a strengthening USD did dampen the rise in oil prices related to the expected reduction in output, but we expect prices to sustain above the USD 50/bbl level. Given the expectations of further future rate hikes, KAMCO Research expects bonds to relatively underperform other asset key asset classes over the medium term, as yields fall, while the performance of equities would be more based on corporate earnings, rather than liquidity driven, as seen in the past.

**Rate hikes adds to GCC's challenges; but current account surplus now a possibility**
Further rate hikes may add to the existing challenges for the GCC in terms of lower growth, the recent cut in oil output and budgetary constraints, as higher borrowing costs are likely to make its way through to corporates and consumers via higher interbank rates. However, we now expect the fiscal deficit in 2017 be lower than the 6.9% of GDP forecasted by the IMF, as higher oil prices post the output cut translate into additional revenues. Also KAMCO Research now sees a return to current account surplus in 2017 as plausible for the region, as against the deficit of 0.5% of GDP forecasted by the IMF, as balance of trade terms could improve if higher oil prices sustain and USD strength persists, leading to lower import bills for the region.

### Fed Fund Rate vs. Kuwait Central Bank Discount Rate




*Data indicates end-of-period target rates/ranges. Source: US Federal Reserve, Central Bank of Kuwait*

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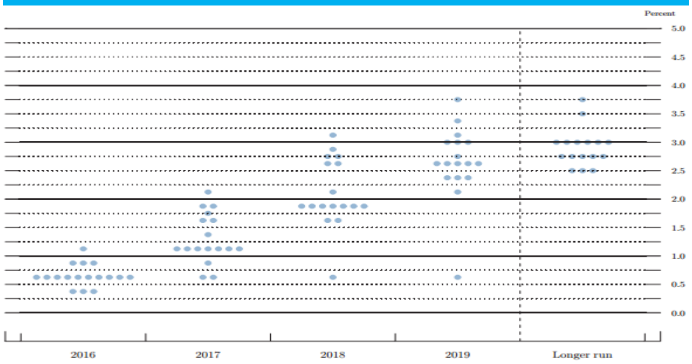
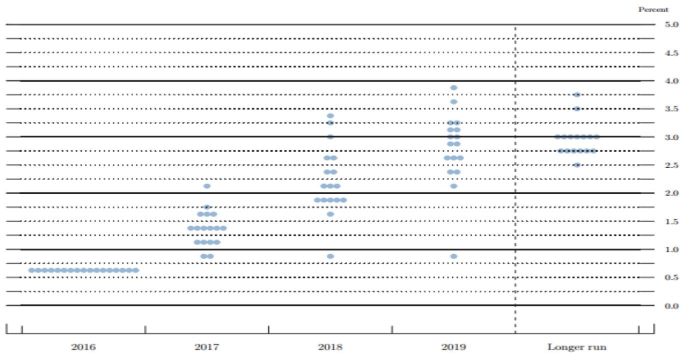
| Fed Dot Plot - September 2016 | Fed Dot Plot - December 2016 |
|---|---|




*Source: US Federal Reserve*

### *Medium term expectations for the US pushed up*

Post 2017, the Fed does see the possibility of benchmark rates in the US reaching above 3%, to an upper end of the range of 3.4% by as early as 2018, whereas the longer term rates post 2019 could inch up to 3.8% on the higher end. Average expectations of policymakers have been pushed up from 2017 onwards by 20-30 bps as compared to their September-16 meeting. The median expectation by the end of 2017 is at 1.4% as compared to previous expectation of 1.1%. Similarly, the average rate projection for 2018 is 2.1%, up from 1.9% in September-16. Real GDP growth on the other hand was revised upward by close to 10bps in 2017 and 2019, while leaving 2018 unchanged, and is expected to average close to 2% p.a. over 2016-19.

**Median Fed Macroeconomic projections (2016– 2019)**

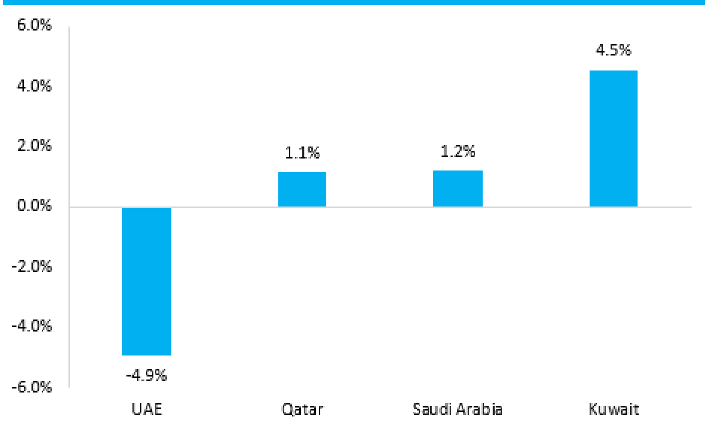
| | 2016 | 2017 | 2018 | 2019 |
|---|---|---|---|---|
| GDP (Y-o-Y%) | | | | |
| Sep-16 | 1.8% | 2.0% | 2.0% | 1.8% |
| Dec-16 | 1.9% | 2.1% | 2.0% | 1.9% |
| Unemployment rate (%) | | | | |
| Sep-16 | 4.8% | 4.6% | 4.5% | 4.6% |
| Dec-16 | 4.7% | 4.5% | 4.5% | 4.5% |
| PCE Inflation (Y-o-Y%) | | | | |
| Sep-16 | 1.3% | 1.9% | 2.0% | 2.0% |
| Dec-16 | 1.5% | 1.9% | 2.0% | 2.0% |
| Fed funds rate (%) | | | | |
| Sep-16 | 0.6% | 1.1% | 1.9% | 2.6% |
| Dec-16 | 0.6% | 1.4% | 2.1% | 2.9% |

*Source: US Federal Reserve*

### *Interbank rates in the region to rise in response to future hikes*

Saudi Arabia's move to keep the repo rate unchanged was likely to ensure that liquidity in the banking sector was still comfortable, and to mitigate interbank lending rates from steeply rising, in our view. The Central Bank of Kuwait also guided that the move to hike rates in response to the Fed's rate hike was to ensure the continued competitiveness and attractiveness of the national currency as a store of domestic savings. Borrowing costs for Kuwait are likely to rise by about 11%, according to our calculations. However, even as overnight interbank rates rose, the 3-month interbank rates exhibited mixed trends as Saudi Arabia, Kuwait and Qatar rates rose, while the rate in the UAE declined from 1.4029% to 1.3336%, as banks would have likely released funds on softer terms. Though some central banks have kept the lending rates unchanged in response to the rate hike in the US in order to keep the liquidity in their economies comfortable, future rate hikes would eventually reflect on in interbank rates and eventually lead to higher borrowing costs in the region.

**Key GCC 3-month interbank rates -1 day change (%)**



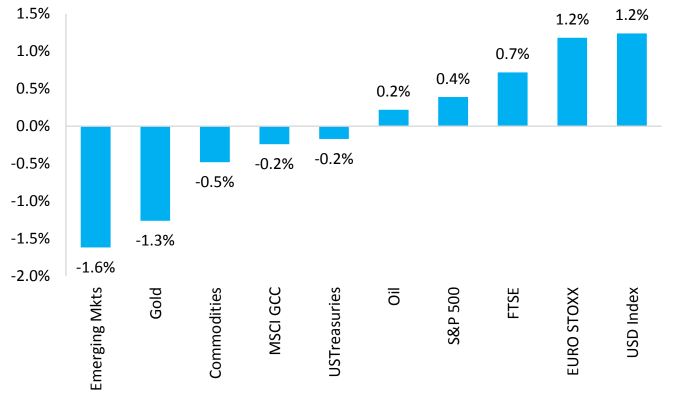

*Source: Respective Central Banks*

### *Early trades post the event suggest that markets are on risk-off mode*

Post the Fed's decision, the market saw typical risk-off trades as emerging markets and commodities barring oil witnessed declines, if single day returns were analyzed. MSCI GCC index was down as well, albeit marginally by 0.2%. Oil remained resilient and range bound inching up marginally by 0.2% post the event. The USD index continued its move up since September 2016 and towards the lead up of the rate hike, and was up by 1.2% following the rate hike as well. Returns for US treasuries understandably declined as yields fell, and are likely to remain under pressure going forward. Developed equity markets in the US, UK and Euro region gained as investors preferred to move safer havens.

USD index strength since September 2016


Asset class returns post Fed rate hike—1 day returns (%)




*Source: Bloomberg, KAMCO Research*

***Deferral of global risks and higher regional revenue potential to hold GCC's 2017 outlook at a balance***

We continue to expect that, GDP growth in the GCC region would bottom out in 2016, and improve in 2017 as higher oil prices would offset production cuts, and international funding initiatives would be incrementally positive for state budgets and future revenues. We expect them to continue to tap the international bond market in 2017, even as Kuwait decides to enter the market, after 2016 witnessed Saudi Arabia raising USD 17.5 Bn in a triple tranche offering, along with Qatar (USD 9 Bn) and Abu Dhabi (USD 5 Bn). However, though we remain optimistic about the measures taken so far by the GCC states, the rollover of several global risks leaves more room for employing additional initiatives to boost non-oil private sector growth. Energy subsidy rationalization and tax related initiatives such as VAT are seen as incrementally positive in our view. Inflation remains well within the ideal range as well, although prices are expected to increase at a slower pace than in 2016, from 3.6% to 2.6% in 2017, as per the IMF. Nevertheless, we see a lot of moving parts both globally in terms of risks, and regionally in terms of potential for higher revenues and better management of state finances, which hold the GCC's outlook in the coming year at a balance, in our view.

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