'This newsletter is translated from the Japanese edition distributed on November 20th
Center for Risk Management Strategy at Deloitte Touche Tohmatsu LLC.

Global Risk Watch Newsletter

Temporary Lull? Before Another Storm in the Financial Market, etc.

Global Risk Watch Vol.8
27 November 2015

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1.Overview Macroeconomic and Financial Risks (Trends & Topics)

 # Temporary Lull? Before Another Storm in the Financial Market (Tsuyoshi Oyama, Partner/Head of Center for Risk Management Strategy at Deloitte Touche Tohmatsu LLC)

The difference in opinions within the FRB among its FOMC members seem to be overcome only to conclude a December rate hike. Indeed, since the FOMC statement in October, FRB Chair Yellen, Vice-Chair Fisher and New York Fed President Dudley’s comments, as well as brighter employment indicators published in early November sent a strong signal that an interest rate hike would occur soon. Meanwhile, the FX market in emerging markets saw a strange moment of tranquility. Although shifting expectations of a US interest rate hike changed from next year to within December of this year, emerging currencies remained stable or slightly appreciated against the USD, which is contrary to the depreciation trends we saw earlier this year. Conventionally, an interest rate hike in the US should trigger capital flow from emerging countries to the US due to the differences in the nominal exchange rate. So what does this imply?

One interpretation is that we are now experiencing a market correction of the previous excessive sell-off of emerging countries' currencies as a result of decreasing "uncertainties" regarding the monetary policy in the US. In fact, some of the central bank officials from emerging countries have already indicated such phenomenon as their expectations in the past. These central bankers believe "an early interest rate hike in the US is better than prolonged uncertainties, whereas to induce positive elements to stabilize FX markets in their respective countries". However, it is still premature to predict the full impact of a US interest rate hike on emerging markets. Economic deceleration in China and various emerging countries have not yet shown any signs of improvement. On the contrary, an increasing number of market participants now believe the scenario that imbalances such as unemployed capital stock and excessive employment became more noticeable only to be addressed in disorderly manner later. In this case, emerging countries that thrived on the back of the Chinese driving commodity cycle will not likely escape the adverse impacts. The US interest rate hike is likely to add its weights gradually on emerging countries through global investors' portfolio rebalancing.

A December interest rate hike in the US will also have an impact on the EU, Japan, and other advanced countries, as well as the US itself. Both the US and EU enjoy a relatively stable economic situation, however, the difference in the stances towards monetary policy between the two central banks, the FRB's focus on cyclical strength and the ECB's focus on structural weakness could induce further uncertainty in the financial market. In addition, whether the US can withstand the double-impacts; increasing pressures of economic deceleration in emerging counties, and the interest rate hike, are to be carefully observed.