VAKIFBANK GLOBAL ECONOMY WEEKLY

When Will The Fed Raise Rates?

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Introduction...

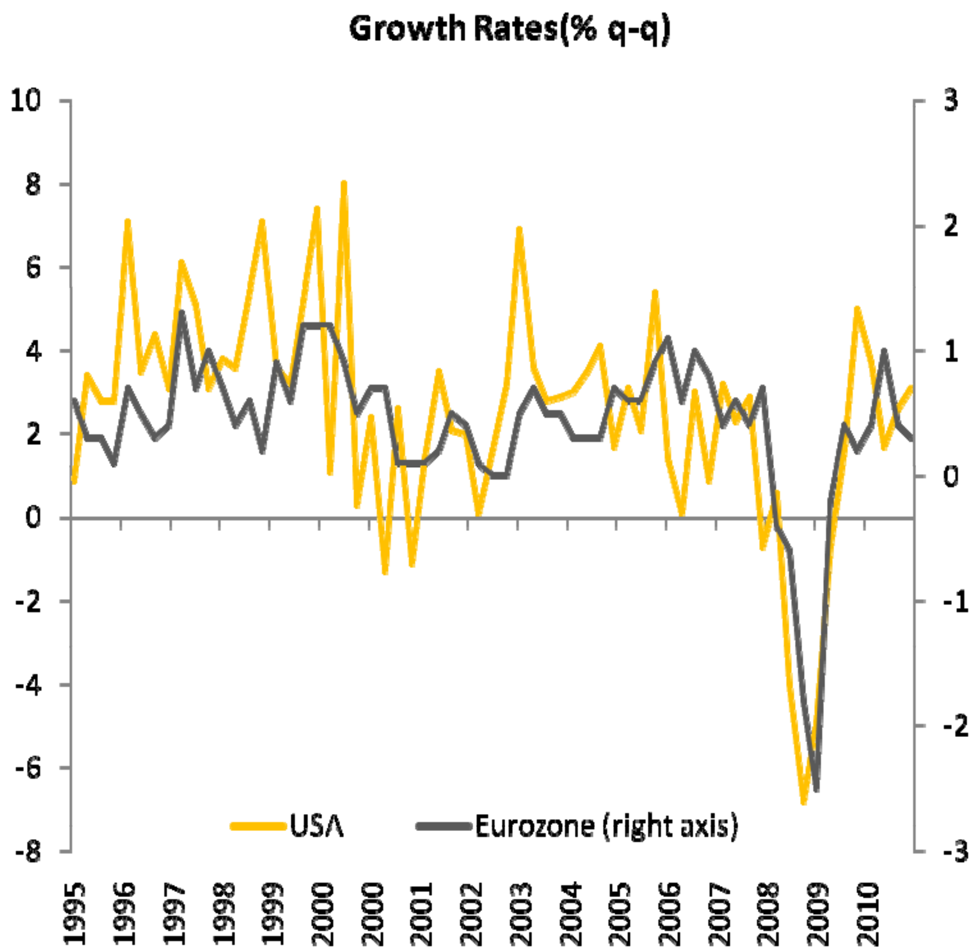
After ECB's policy rate hike, markets are corncerned about weather Fed will be the next or not. Since US inflation rate is relativeley lower compared to Euro Zone and unemployment rate is still at high levels, FED is not expected to start rate hike before Q1 of 2012. In this study the main reasons behind the present disintigration of ECB and Fed monetary policies are analyzed under three headlines;

1) *Despite positive growth data, fragility of US economy still continues*

2) *US unemployment rate is still above the pre-crisis levels*

3) *Inflationary pressure in Eurozone is higher than US*

Despite positive growth data, fragility of US economy still continues...

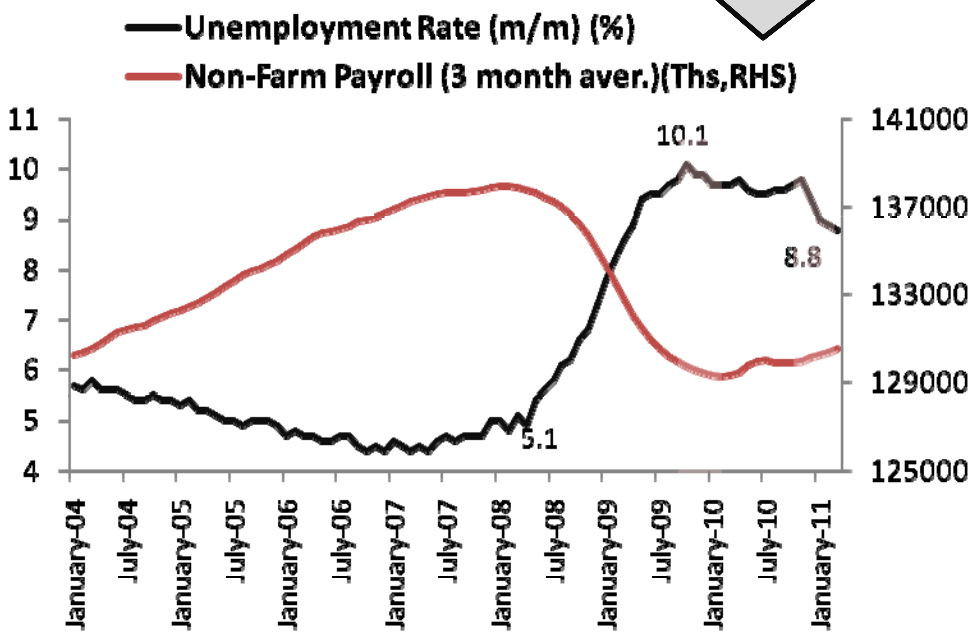


Source: Bloomberg

- US and Eurozone growth rates usually follow a collateral progress, but rates decay in some periods. These periods are territorial crisis periods such as Eurozone debt crisis.
- The unemployment rate and sustainability of growth are the main indicators for Fed rate hikes. On the contrary ECB takes inflation rates into account for rate hike.
- Fed is not expected to hike rates before 2012 as;
  - Household wealth is much more fewer than pre-crisis levels.
  - Household spending follows a weak crawl.
  - Housing sector has not been recovered yet.
  - Unemployment rates and oil prices have remained at high levels.

US unemployment rate is still above the pre-crisis levels...

In the past it often took five or six years for the unemployment rate to come down from its post recession highs towards pre-recession lows.

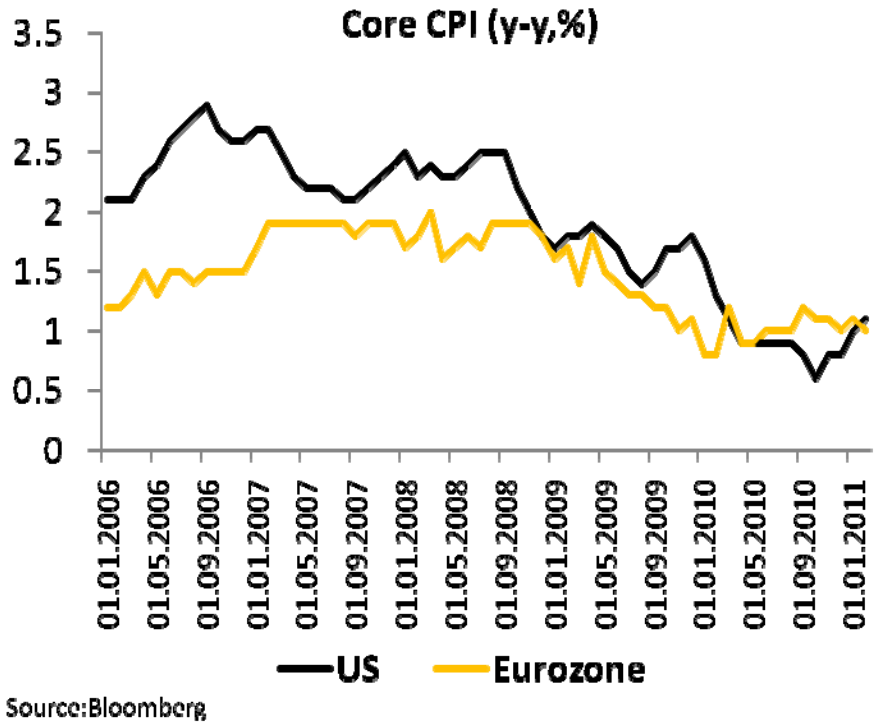


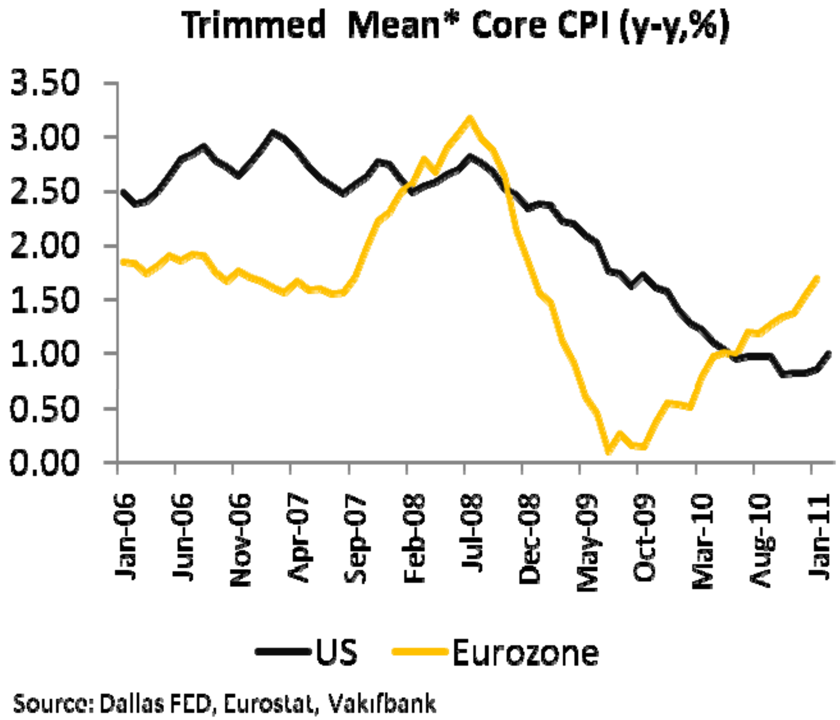
Source: Bloomberg

- Although US unemployment rate has recently decreased to 8.8% from its peak level of 10.1%, it is still above the pre-crisis levels.
- Despite the rise in non farm payrolls, the high unemployment rate reflects the fragility of the US economy.
- Considering all these, persistently high unemployment rates are expected to keep the Fed from raising interest rates before Q1 of 2012.

- When the relationship between the unemployment rate and Fed rate is analyzed, it is seen that FED has restarted monetary tightening in six months after the average unemployment rate declined by 0.7%. According to this analysis, FED could raise rates in July 2011, six months after average unemployment rate declined by 0.7% from the historical highest level of 10.1%. However, due to low inflation and the recent housing data indicating slow recovery in housing sector, a rate hike seems to be impossible before 2012.

Inflationary pressure in Eurozone is higher than US...



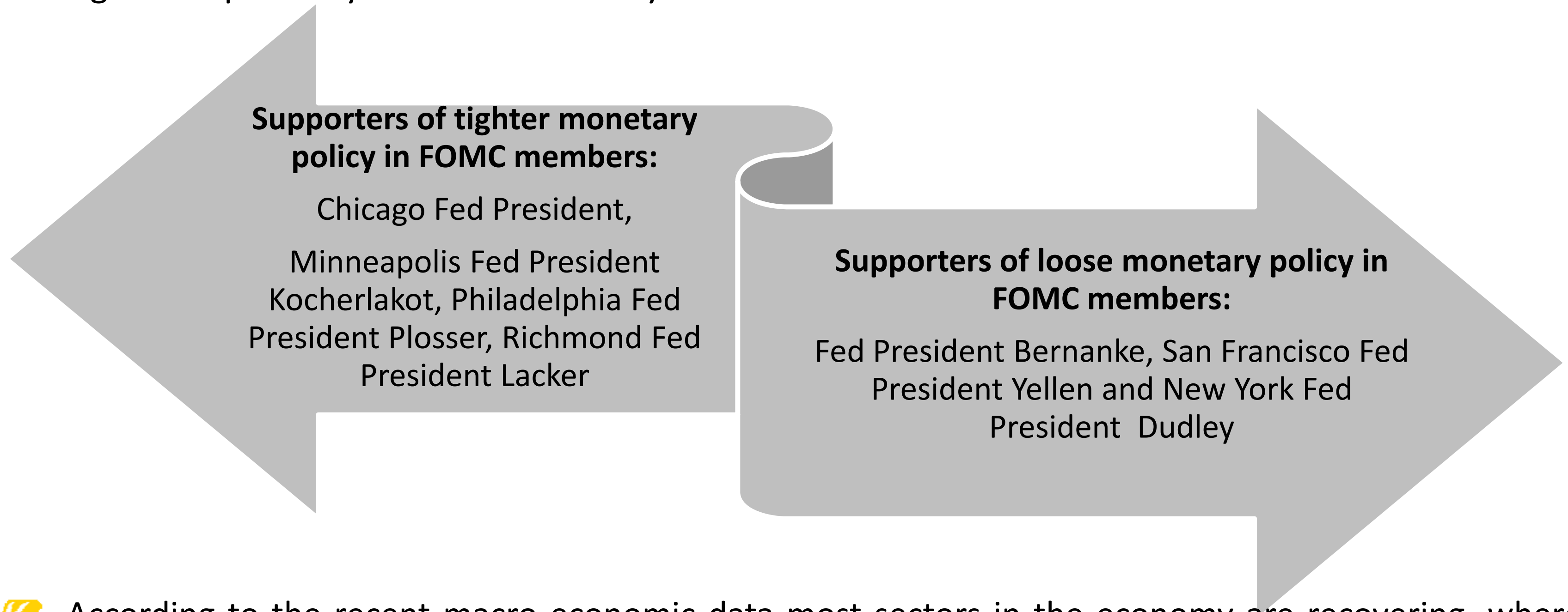


* A method of averaging that removes the most volatile components of the index.

- Core inflation excluding food and energy reached 1.0% YoY in the Eurozone and 1.1% in the US in February. Then, just looking the traditional core measures, Eurozone and US has similar trends.
- However, the traditional core inflation is not the best measure of headline inflation. Looking for an alternative measure as the Trimmed Mean methodology changes the result. The new core inflation measure suggests underlying inflationary pressure has been higher in Eurozone than US. Moreover, it has been increasing since May 2009 in Eurozone, however, in US it has a decresing trend until February.
- It is seen that the US trimmed mean core CPI measured by Dallas FED started to increse in February. This is a significant sign of inflationary pressure risks for US. Therefore, it is important to follow this measure in the comming months to decide when FED will start to increse its policy rate.

Recent Regional Fed Presidents' speeches and summary...

- After the end of Fed's Treasury Bond Purchase Programme in June 2011, a new QE programme is not expected to be imposed. Moreover the recent speeches of the some Regional Fed Presidents signal the possibity of a rate hike this year



- According to the recent macro economic data most sectors in the economy are recovering, whereas the housing market remains weak. Thus the fragility of economic growth still continues in US.

- It is expected that the current rises of energy and food prices will only provide a transitory boost to US inflation.

- In the light of these informations, the first Fed tightening move is expected to take place in early 2012. But If the inflation has moved up sharply, there is risk that Fed might start rate hike in the second half of 2011.

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