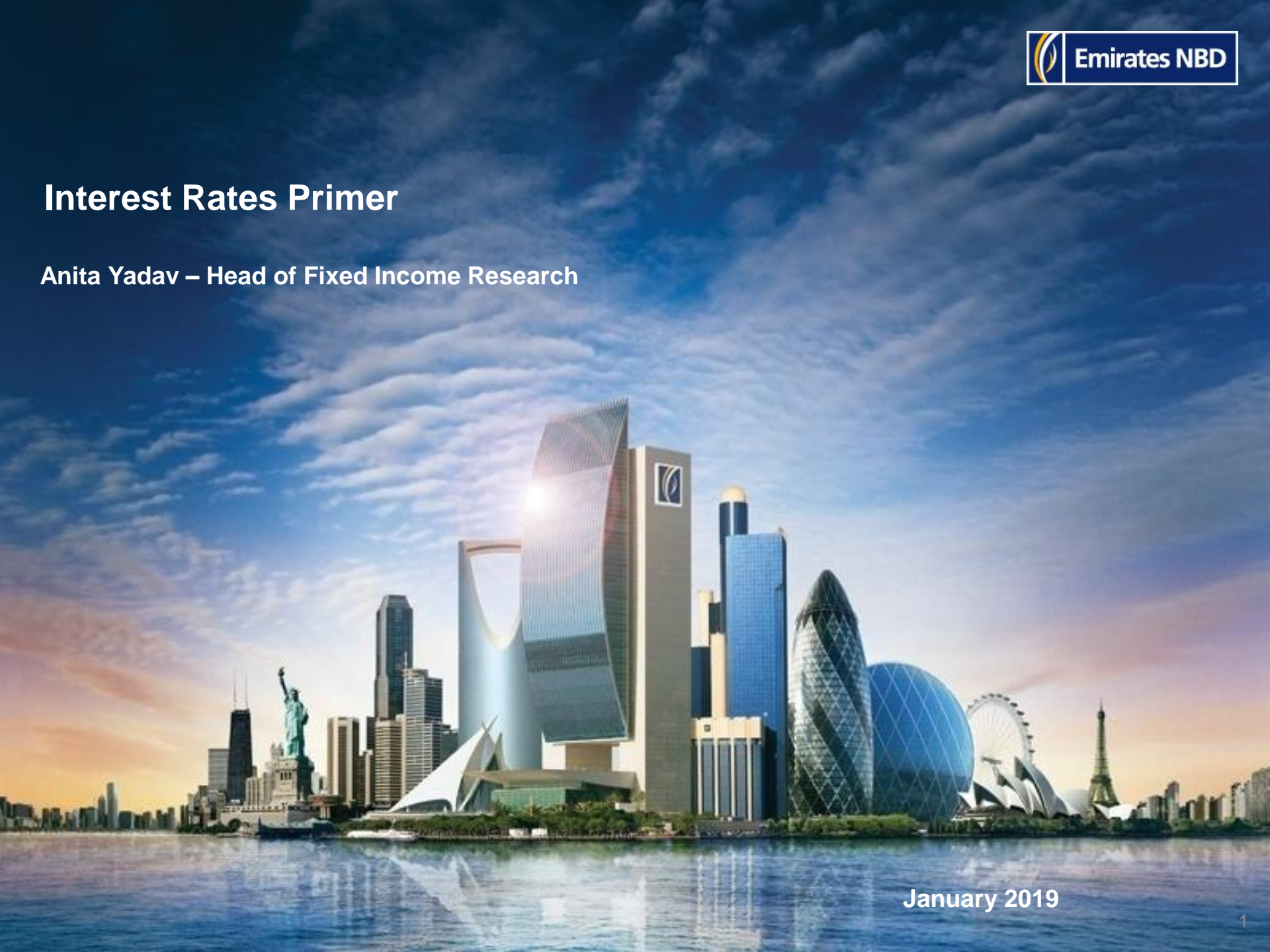


Interest Rates Primer

Anita Yadav – Head of Fixed Income Research



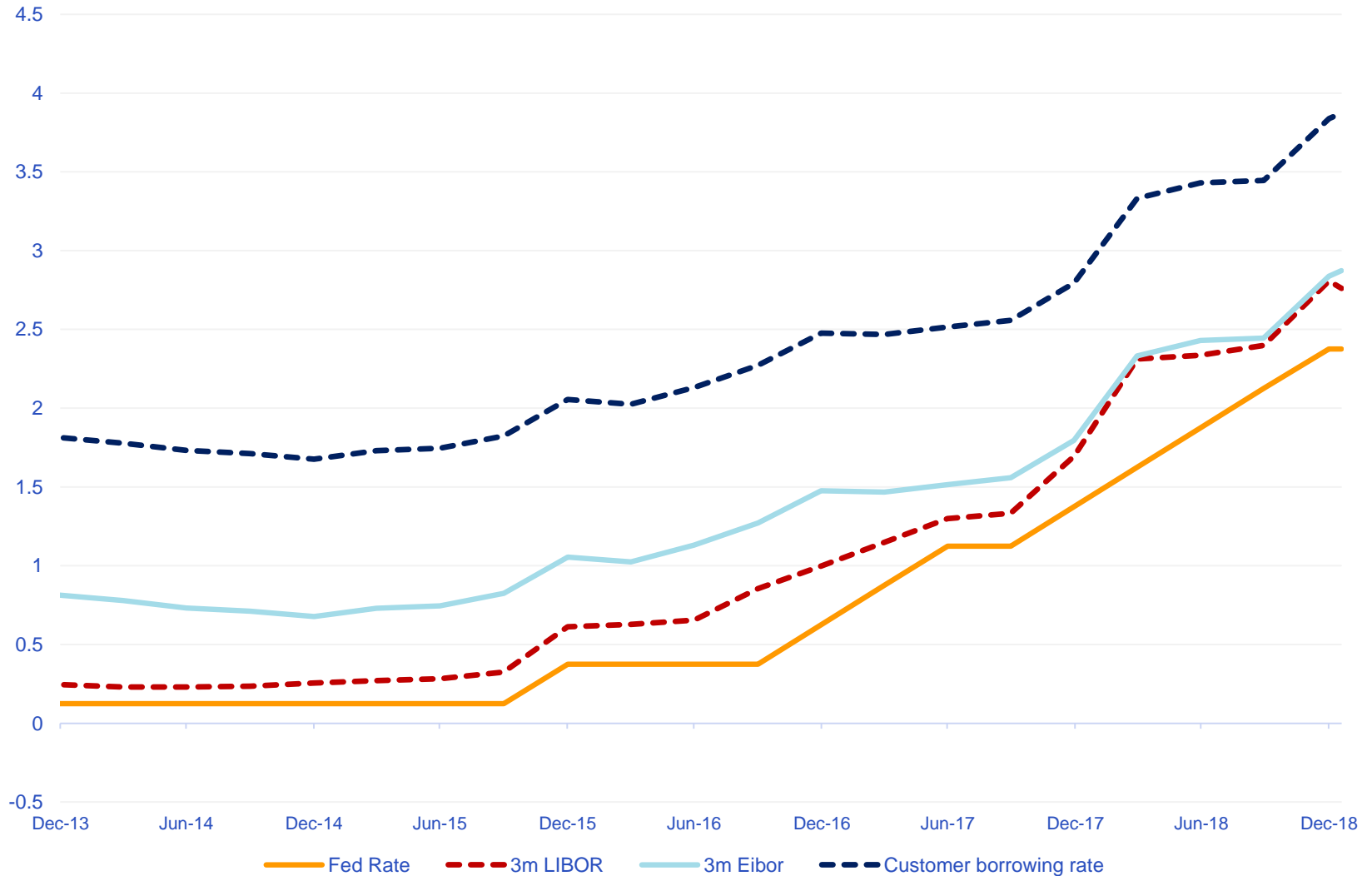
January 2019

Content

- Fed Target Rate
- Local Central Bank Policy Rates
- Interbank Rates
 - USD LIBOR and USD swaps
 - EIBOR and Dirham swaps
 - SAIBOR and SAR swaps

Interest Rates Pyramid

Transactions between the central banks and commercial banks/dealers in any jurisdiction are generally done at the target rate / policy rates while interbank rates such as LIBOR and EIBOR generally form the benchmark for commercial transaction between banks and their customers.



US Fed Target Rate

Besides many qualitative considerations, the Federal Reserve's Monetary policy Committee (FOMC) looks at three main economic indicators for making their target interest rate decisions

- GDP growth
- Core Inflation
- Unemployment rate

The current Dot Plot indicates two more rate hikes this year followed by one next year.

However several other factors such as a) growth outlook, b) global risks; c) currency strength; d) consumer confidence; e) dovish/hawkish bias of the FOMC voters etc. play significant role in interest rate decisions.

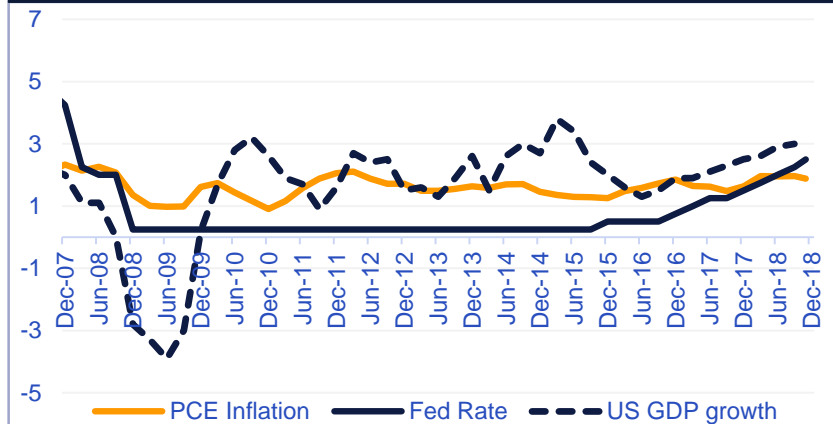
Date	US GDP growth %	Core PCE inflation %	Unemploy rate %	Fed Rate - Upper
12/31/2018	3.00	1.98	3.80	2.50
12/31/2017	2.27	1.71	4.01	1.50
12/30/2016	1.49	1.72	4.70	0.75
12/31/2015	2.86	1.37	5.00	0.50
12/31/2014	2.57	1.57	5.70	0.25
12/31/2013	1.68	1.49	6.93	0.25
12/31/2012	2.22	1.78	7.80	0.25
12/31/2011	1.60	1.86	8.63	0.25
12/31/2010	2.53	0.97	9.50	0.25
12/31/2009	-2.78	1.42	9.93	0.25
12/31/2008	-0.29	1.64	6.87	0.25
12/31/2007	1.78	2.25	4.80	4.25
12/31/2006	2.67	2.16	4.43	5.25
12/31/2005	3.35	2.26	4.97	4.25
12/31/2004	3.79	2.09	5.43	2.25
12/31/2003	2.81	1.37	5.83	1.00
12/31/2002	1.79	1.75	5.87	1.25

Source: Bloomberg

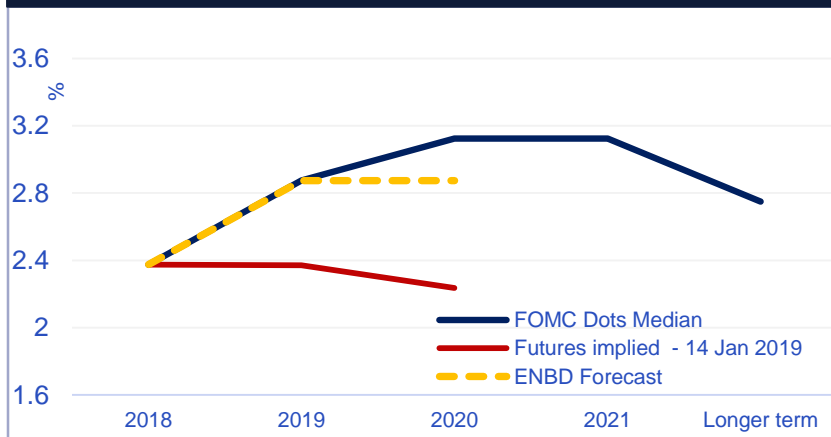
Highlights

- Recent political and trade developments could potentially be quite destabilizing both for the economic growth as well as for financial markets. In addition, 'hard' data out of the US has become a little more mixed compared with previous quarters.
- Market implied probability has dropped from rate hikes to rate cut this year. Fed officials have begun to consider halting rate hikes or at least be more patient – a sign of receding confidence about the future outcome of the current events.

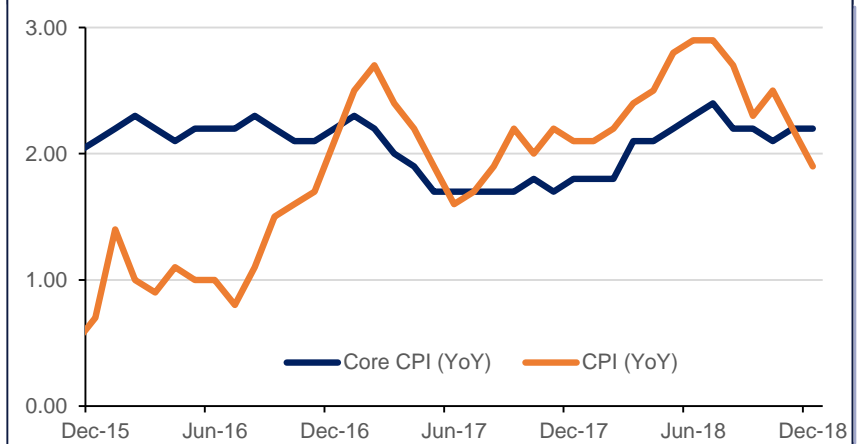
Fed rate vs GDP and inflation



Markets more dovish than the Fed



Core Inflation is above the Fed's 2% target



Highlights

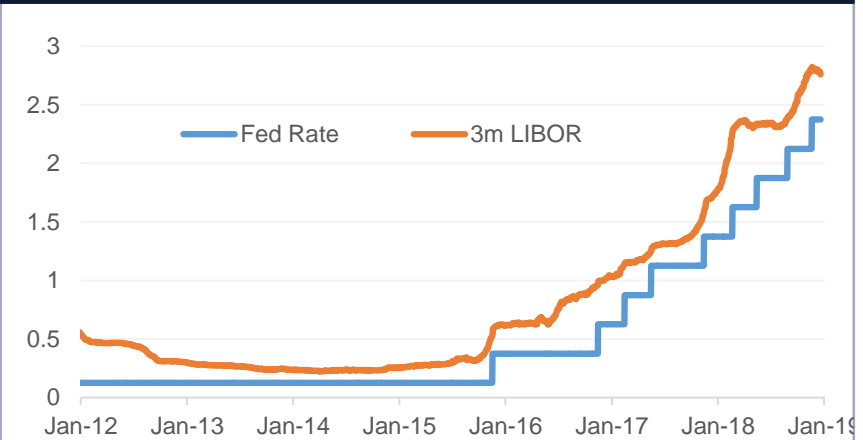
Though the Fed does not control interbank rates, LIBOR (London interbank offered rate) rates for USD tend to move in the same direction as the Federal fund's rate.

However, in times of turmoil or extraordinary events, the divergence between LIBOR and Fed rates can be sizeable. Factors affecting LIBOR rates are:

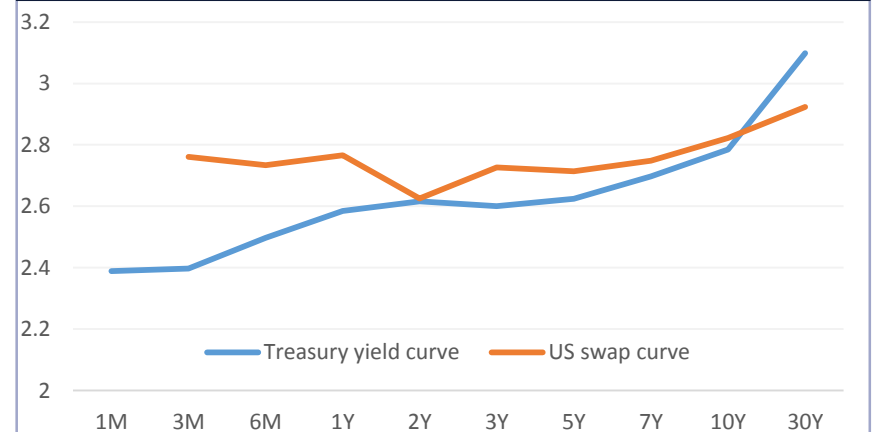
- The Fed's target rate.
- Term premium (1wk to 12 months).
- QE or change in reserve requirements.
- Liquidity in the banking system.
- Credit quality of the banks.
- Regulatory changes.

Long term interbank rates i.e. swap rates theoretically should follow the direction of the treasury yield curve. However, demand supply dynamics in the industry can cause negative spreads as is the current case in tenures beyond 20yrs.

Libor vs Fed Rate



US swap rates lower than UST yields in the longer end



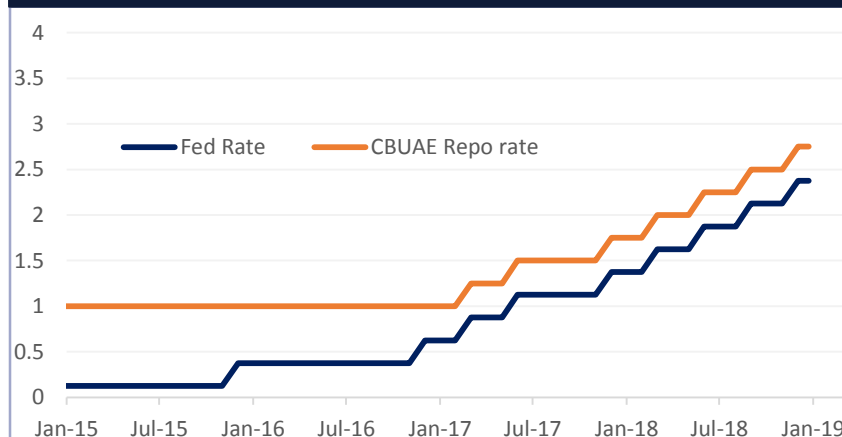
Highlights

- Given Dirham's peg to the dollar, policy rates in the UAE (mainly the CBUAE's repo rate) generally move in tandem with the Fed target rate.
- The UAE central bank has some flexibility to affect the liquidity in the banking system via altering the amount and interest rate offered on Certificates of Deposit.

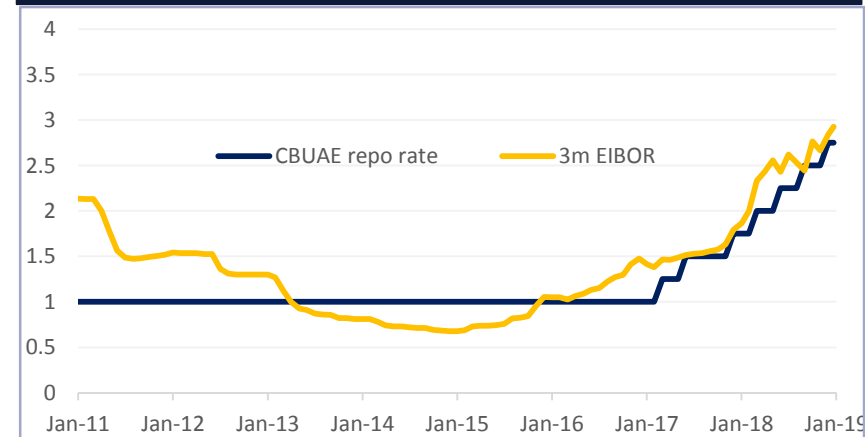
Cut Off rates (5%) for CDs issued by the CBUAE

Tenor	Rate (20 Jan 19)	Rate (18 Jan 2018)
1Week	2.25	1.249
1Month	2.32	1.25
2Months	2.34	1.33
3Months	2.37	1.45
6Months	2.46	1.59
9Months	2.49	--
12Months	2.54	1.8095

CBUAE repo rate vs the Fed target rate (mid)



EIBOR vs CBUAE repo rate

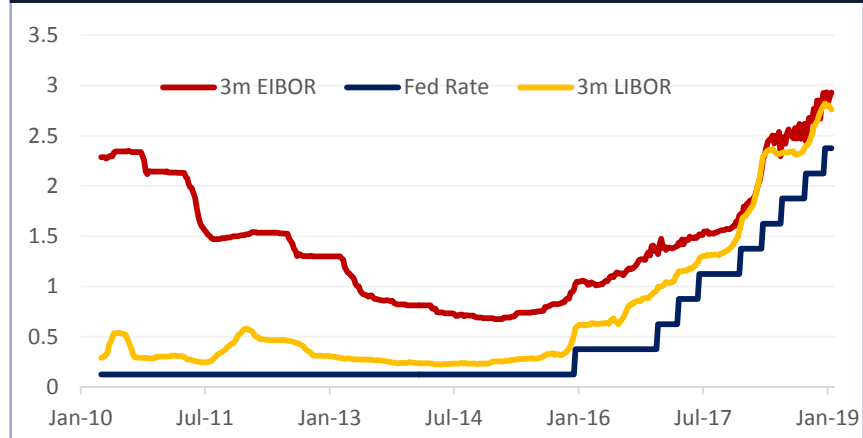


Highlights

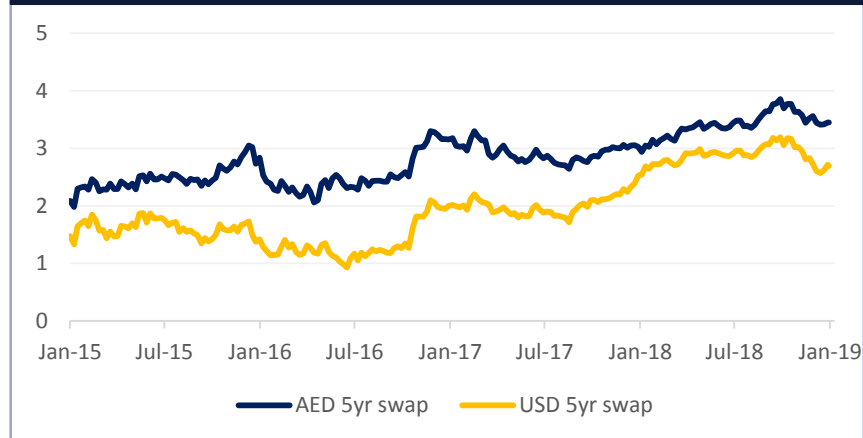
- The dirham interbank rates, EIBOR, rates are set by averaging the rates submitted by 8 panel banks (ENBD, FAB, ADCB, HSBC, StanChart, Mashreq, CBD and UNB) after excluding the two highest and two lowest rates.
- Loan growth slowed in the recent past on the back of slow economic growth while deposits in the banking system increased as oil prices were higher in 2018 – causing liquidity in the UAE banking system to improved. This in turn compressed the EIBOR – LIBOR spread.

EIBOR Rates as at 20 Jan 2019			
O/N	2.0065	3Month	2.9275
1 week	2.36483	6Month	3.1063
1Month	2.59375	12Month	3.5233

3m EIBOR vs 3m LIBOR



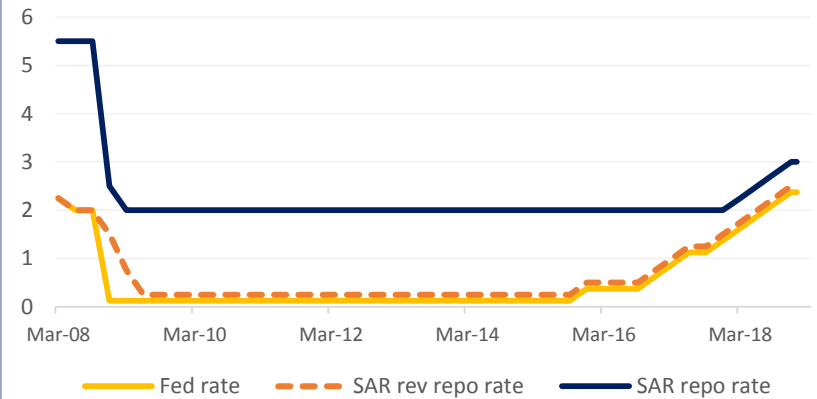
AED vs USD swap curve



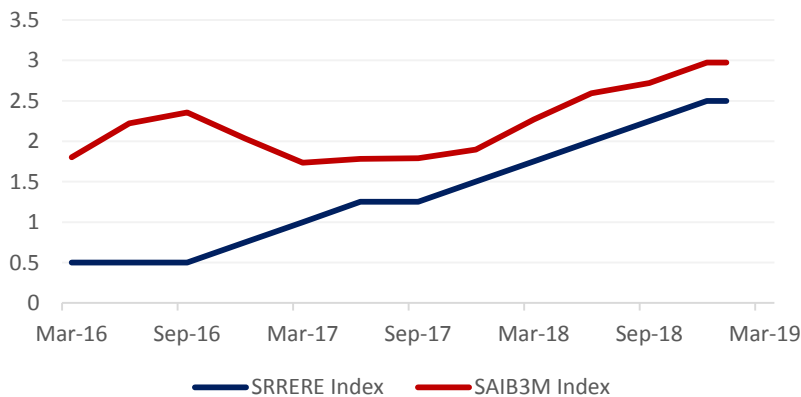
Highlights

Very much like in the UAE, policy rates in the Saudi Arabia move in tandem with the Fed target rate. In absence of efficient local currency capital markets to affect the amount of cash in the system, GCC central banks tend to have separate deposit and lending rates instead of just one target rate. SAMA exercises some flexibility by altering the spread between the repo and the reverse repo rates.

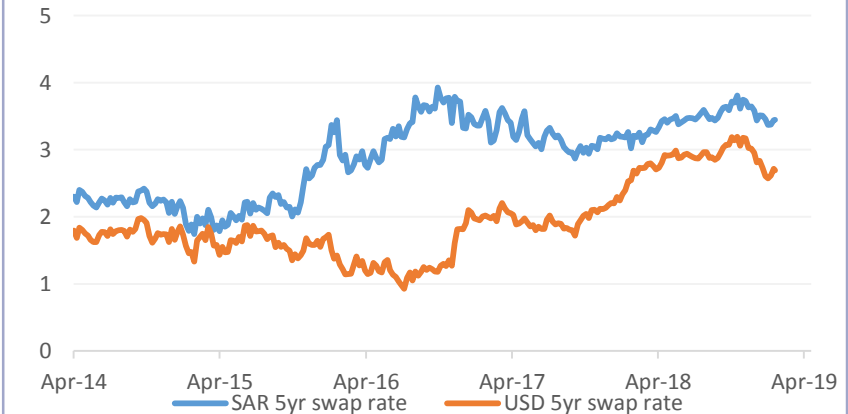
SAMA target rates



SAR rev repo vs 3m SAIBOR



SAR vs USD swap rates – 5yr tenure

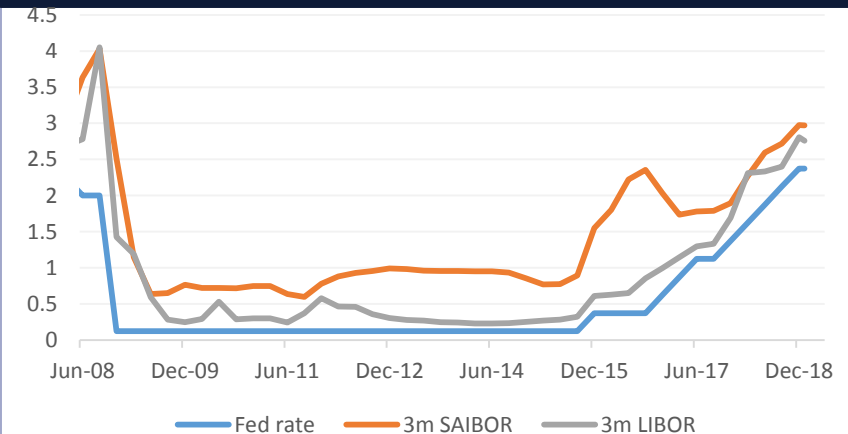


Highlights

Besides policy rates, SAMA also engages in using other tools such as below for managing the liquidity in its banking system.

- Changing the required Loan-to-deposit ratio limit to be observed by banks.
- Reducing or increasing the issuance of T-bill and other government debt in the local market.
- Altering / increasing the available repo window from one day maturity to 1 week or 1 month or 3months etc.
- Curbing speculative trading in FX which in turn helped containing capital outflow ensuing from de-peg fears.
- There are 12 banks on the panel contributing rates for SAIBOR setting. Rates are set by excluding two highest and two lowest rates and averaging the remaining 8 quotes.

SAIBOR vs LIBOR



SAIBOR Fixing

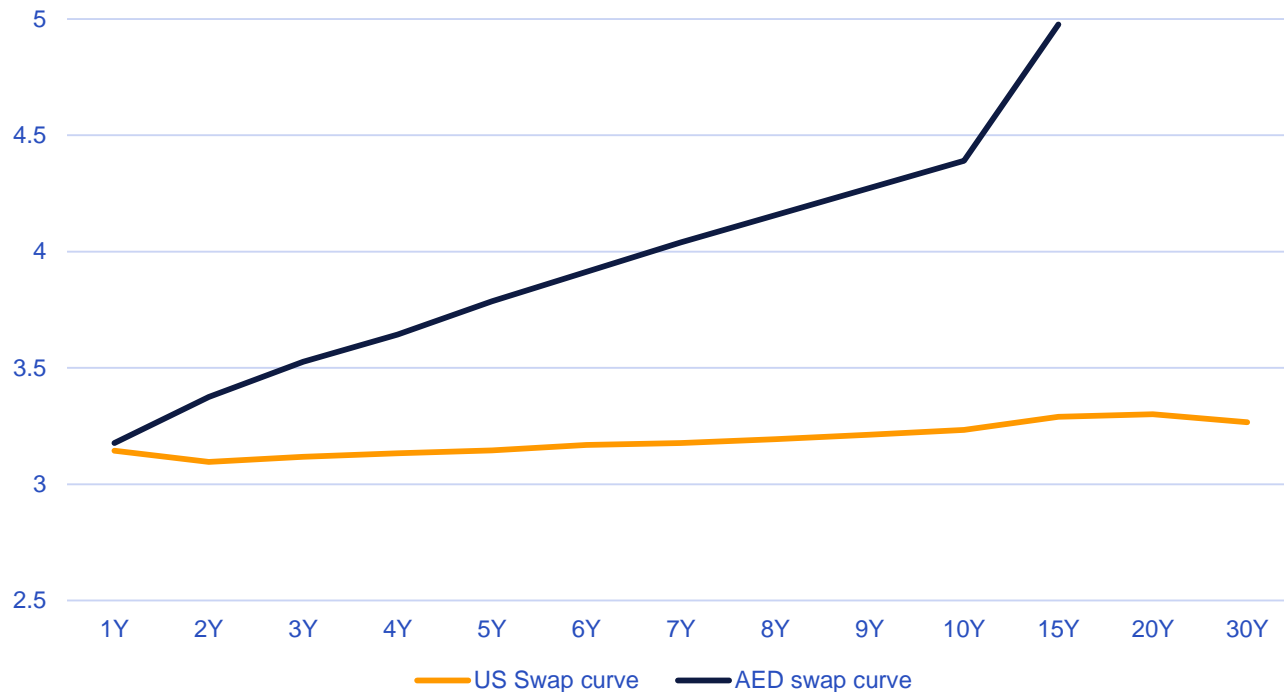
3M SAIBOR Fixing 2.97125

Contributors as at 20 Jan 2019

ANB	2.97	SBB	3
BAJ	2.95	SAMBA	2.93
ALAWWAL	3	SINB	3.01
BFSR	3.02	ALIN	2.98
NCB	2.97	BAB	2.97
RYB	2.91	ALRB	2.91

Are AED swap rates too steep ?

The AED swap curve is established with an estimated fixed rate against 3m EIBOR as the floating rate on a day count of ACT/360 and the US swap curve is based against 3m LIBOR as the floating rate on a day count of ACT/360 with quarterly payment frequency.

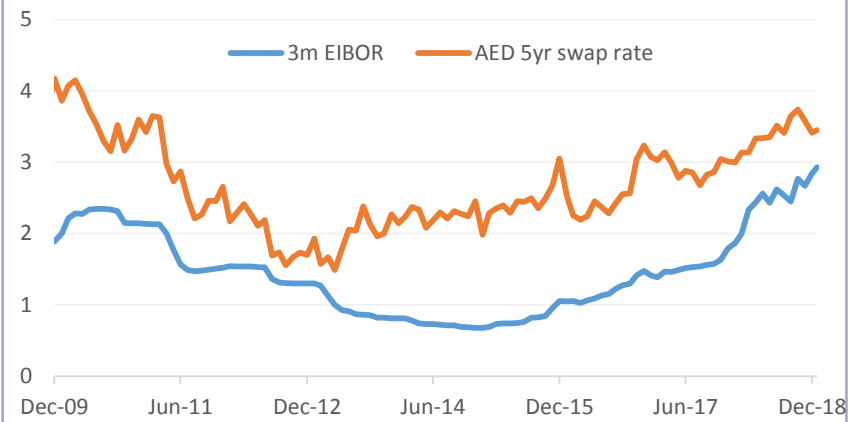


Highlights

Though swap rates should generally move in sync with the interest rate expectations, the relationship is not linear. Swap rates get materially affected by:

- Demand supply dynamics – including demand from corporate clients to hedge.
- Speculation – since it needs minimal upfront funding.
- Counterparty risk – though this is largely negated these days with presence of centralized clearing counterparty.

AED 5yr swap rate vs 3m EIBOR



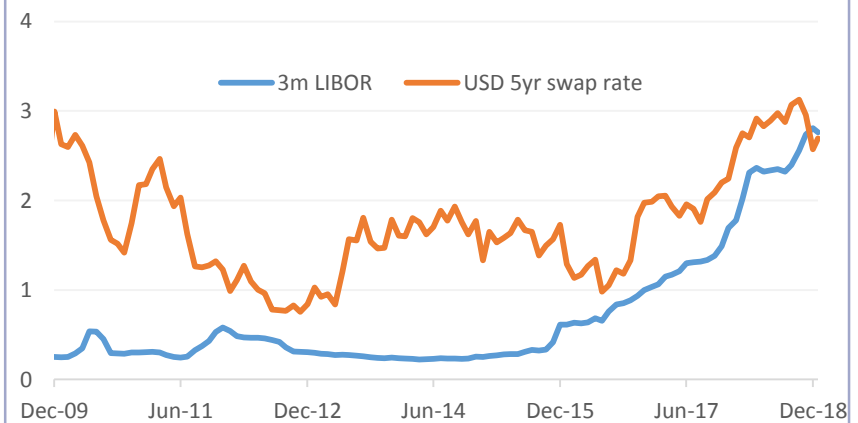
Source: Bloomberg, Emirates NBD Research

5yr AED swap spread over USD swap



Source: Bloomberg, Emirates NBD

USD 5yr swap rate vs 3m LIBOR



Rates forecast

	Current	3M	6M	12M
Market Rates				
10yr UST yield	2.78	2.85	3.05	2.90
2yr UST yield	2.61	2.67	3.00	3.10
3m LIBOR	2.77	2.80	3.00	3.25
3M EIBOR	2.93	3.00	3.20	3.50
Policy Rate				
FED	2.50	2.50	2.75	3.00
ECB	0.00	0.00	0.00	0.00
BoE	0.75	0.75	0.75	0.75
BoJ	-0.10	-0.10	-0.10	-0.10
RBI (repo)	6.50	6.25	6.00	6.00
SAMA (r repo)	2.50	2.50	2.75	3.00
UAE (repo)	2.75	2.75	3.00	3.25
CBK (discount rate)	2.50	2.50	2.75	3.00
QCB (Repo rate)	2.50	2.50	2.75	3.00
CBB (o/n depo)	2.50	2.50	2.75	3.00
CBO (o/n repo)	3.00	3.00	3.25	3.50

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