Qatar-GCC situation fluid and unresolved; Another surprising UK election: Fed poised to hike this week

Key market indicators

Stock markets	Index	Change (%) weekly	Change (%) YTD
Regional			
Abu Dhabi SM	4,477	-0.05	-1.13
Bahrain ASI	1,323	-0.13	8.44
Dubai FM	3,400	1.44	-3.68
Egypt EGX 30	13,684	1.61	10.84
S&P GCC 40	1,070	-1.45	-7.36
Kuwait SE	6,783	-0.44	18.01
KSA Tadawul	6,865	0.03	-4.78
Muscat SM 30	5,355	-1.48	-7.45
Qatar Exchange	9,238	-7.06	-12.24
International			
CSI 300	3,576	2.57	8.04
DAX	12,816	-0.06	11.62
DJIA	21,272	0.31	7.64
Eurostoxx 50	3,586	-0.16	8.98
FTSE 100	7,527	-0.27	5.38
Nikkei 225	20,013	-0.81	4.70
S&P 500	2,432	-0.30	8.62

Commodities	$/unit	Change (%) weekly	Change (%) YTD
Brent crude	48.2	-3.60	-15.26
KEC	45.6	-4.77	-12.87
WTI	45.8	-3.84	-14.69
Gold	1268.5	-0.65	10.30

Exchange rates	Rate	Change (%) weekly	Change (%) YTD
KWD per USD	0.30	-0.02	-0.78
KWD per EUR	0.34	0.29	7.35
USD per EUR	1.12	-0.78	6.46
JPY per USD	110.33	-0.06	-5.60
GBP per USD	1.274	-1.10	3.27
EGP per USD	18.11	0.89	0.61

Interbank rates	%	Change (bps) weekly	Change (bps) YTD
Bhibor - 3 month	2.20	0.0	10.0
Kibor - 3 month	1.63	0.0	18.8
Qibor - 3 month	2.16	24.1	38.2
Eibor - 3 month	1.49	0.8	2.0
Saibor - 3 month	1.73	0.9	-30.1
Libor - 3 month	1.23	1.0	23.9

Bond yields	%	Change (bps) weekly	Change (bps) YTD
Regional			
Abu Dhabi 2021	2.38	8.4	-15.5
Dubai 2021	2.94	5.1	-36.0
Qatar 2021	3.03	61.4	9.5
Kuwait 2022	2.54	4.4	n/a
Saudi Arabia 2022	2.92	9.4	n/a
International			
UST 10 Year	2.20	4.0	-23.3
Bunds 10 Year	0.26	-0.7	5.5
Gilts 10 Year	1.01	-3.2	-23.4
JGB 10 Year	0.06	0.2	0.7

Source: Thomson Reuters Datastream; as of Friday close

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Summary

Very busy time on the news front, with UK and French elections, Fed and ECB meetings, and a major diplomatic and trade relations flap between Qatar and some of its neighbors. Volatility remained subdued in advanced markets. However, the dispute between Qatar and several of its GCC neighbors took a toll on local markets, especially Qatari stocks and bonds, with equities down 7% and bond yields up almost 20 bps in the last few days. Ratings agency S&P also downgraded Qatar's long-term debt in the wake of the fallout. The impact on other GCC markets was further exacerbated by lower oil prices; Brent dropped 3.6% on the week and remains down 15% so far in 2017.

While the Qatari crisis seems more serious than previous episodes, the involvement of mediators from the US and Kuwait could help to contain the dispute and hopefully bring about a swifter resolution. Oil was pressured further in the week by rising inventories. Prices were unable to rise above $ 50 pb (Brent).

The Fed will meet this week and almost certainly hike the federal funds rate by 25 bps. The ECB, which met last Thursday, announced no change in policy, but tweaked its language to signal a slightly less accommodative future stance. Politically, the long-awaited testimony by fired FBI Director James Comey did not change the landscape much at this point. It failed to further damage President Trump and his agenda. The markets are still counting on tax and health care reform ahead, though the timing remains very uncertain.

The UK election last week saw another political surprise. PM May failed to garner the larger majority that she was seeking and expecting. Instead, she found herself in a precarious position, having to rely on one of the smaller parties to form a new government. The prospect of a hung parliament and associated uncertainty weighed on the pound, with the likely path of Brexit negotiations even cloudier now.

The French election is in store today, with polls expecting Mr. Macron, the new president, to garner a hefty majority. This will perhaps allow him to make the deep reforms that have eluded France in the past.

International macroeconomics

USA: Data is yielding little by way of surprises, with no major release last week. Consumer confidence and sales remain moderate to firm. The JOLTS report showed a high level of job openings. The PMI for services for May rose a bit to 53.6 from 53.1, showing decent growth in the largest segment of the economy.

In light of the above, the Fed should act this week and hike the federal funds rate target by 25 bps to 100-125 bps. The markets are ready and have priced this outcome. 2-year notes are trading at 1.31%. What happens next is more uncertain. The solid, previous consensus of another similar hike in December this year, followed by further hikes in 2018, seems more diffuse at this point as investors have become a bit more cautious; this is partly because inflation is still low and partly because of

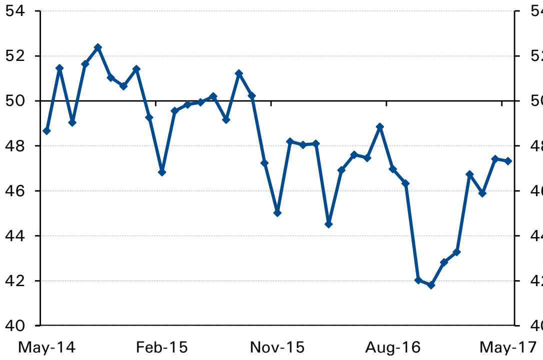
Chart 1: Kuwait trade balance

(KD billion)

Source: Central Statistical Bureau

Chart 2: Egypt PMI

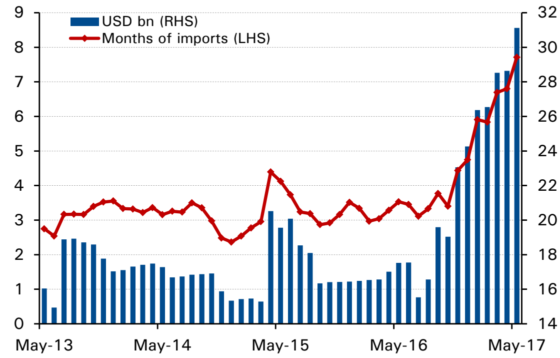
(index)



Source: Markit

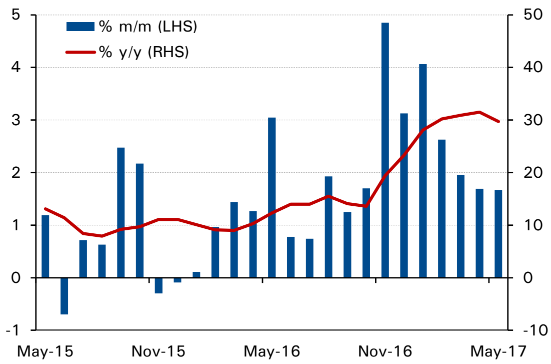
Chart 3: Egypt external reserves

(CBE foreign reserves)



Source: CBE, Thomson Reuters Datastream, NBK estimates

Chart 4: Egypt inflation



Source: Central Bank of Egypt

rising doubts about Trump's tax cuts and stimulus plans. The Fed/FOMC meets 13-14 June.

Eurozone: The ECB revised its Eurozone (EZ) growth outlook upwards by 0.1% for each year from 2017 through 2019. EZ GDP is now expected at 1.9% for 2017, 1.8% in 2018, and 1.7% in 2019. This followed an upward revision of 1Q17 GDP, which came in at 0.6% q/q and 1.9% y/y. Meanwhile, inflation expectations have been pared down, reflecting uncertainty over the future pick-up in energy prices. Inflation is now seen at 1.5% in 2017, 1.3% in 2018, and 1.6% in 2019.

The European Central Bank announced that Banco Popular Español was a failing or soon-to-fail bank. To avoid financial distress, the bank was sold to Banco Santander for a nominal fee of EUR 1. Banco Santander will raise EUR 7 billion in a rights issue to bolster Banco Popular's balance sheet. The merger also now makes Banco Santander the largest lender in Spain.

A reformative electoral law that was supposed to usher in early elections in Italy failed to pass parliament. Markets reacted positively to less likely elections this year.

UK: They were sure of a landslide but came away with crumbs. How the conservatives lost a 20-percentage point lead in the polls, a difference that was greater than the Labor's Party's entire expected share of the vote, will undoubtedly go down as one of *the* epic miscalculations of modern times. The Tories finished with 318 seats in parliament. They were expecting more than 431 seats. Moreover, they lost the 12 seat majority they had secured under David Cameron in 2015 and now need the support of the Democratic Unionist Party (DUP) of Northern Ireland, whose 10 seats would be sufficient to form a workable government. But the omens for minority governments are not good. Each of the last three governments since the 1970's has barely lasted a year, prompting a return to the polls.

Labor, for its part, with Jeremy Corbyn at the helm, outdid itself, capturing 41% of the national vote from 30.4% in 2015, including a sizeable share of the youth vote (the youth turnout hit 69%, a notable increase from 2015's 43%), urbanites, Brexit remainers and some of the elderly who had been angered at the Tory manifesto's pledge to charge them for their own health and social care.

In a way, it could be argued, Conservatives did not actually do badly; they increased their share of the vote by 5 percentage points from 36.9% in 2015 to 42% this time, which is their best result since Margaret Thatcher's era. They also gained several seats in Scotland, a Tory wilderness, at the expense of the Scottish National Party (SNP), which would have been unthinkable only last week.

What of Brexit? More uncertain than ever, with a government and a legislature that are now thought to be less inclined towards hard Brexit.

The prospect of a hung parliament raises uncertainty at a time when the UK embarks on the most challenging negotiations in generations. Sterling was first casualty, dropping 2.5% against the dollar at one stage before settling down at 1.274, a fall of 1.7%. Against the euro, Sterling was off 1.5% at 1.137 by Friday's close. In contrast, the FTSE-100, perhaps sensing the prospect of a softer Brexit favored by businesses, finished up 1.0%.

Government bonds yields meanwhile ended lower 10-year gilts down 2 bps to 1.01%.

GCC & regional macroeconomics

Kuwait: Credit growth improved in April, even as the month saw outstanding credit flat. Growth rose to 4.0% y/y. The poor monthly showing was mostly due to the regular start-of-quarter drop in loans for the purchase of securities. Growth in "productive" business sectors remained strong.

The National Assembly approved the budget for FY17/18, projecting a deficit of KD 7.9 billion (21% of GDP). Revenues are seen up 30% to KD 13.3 billion on a $45 oil price assumption, while expenditures are projected to grow by 5.3%. We think the deficit will be closer to KD 5.2 billion (14% of GDP) on a higher Kuwait crude price of $52 and more modest spending growth of around 4%.

The trade surplus was steady at KD 1.6 billion in 1Q17 despite a jump in imports, after oil export revenues stabilized. Imports grew by 11% y/y following a period of weaker growth. (Chart 1.) Capital goods imports remained robust, boosted by strong domestic investment. After three quarters of double-digit contraction, growth in consumer goods imports appeared to stabilize.

Qatar: Qatar found itself isolated and sanctioned amid a diplomatic row with several of its GCC neighbors over its alleged support for Islamist extremists and its close ties to Iran. Saudi Arabia, the UAE, Bahrain and Egypt broke off relations with the gas-rich emirate, recalling all their ambassadors, closing all land and sea links and ordering all Qatari nationals to leave their countries within 2 weeks. Qatar was also expelled from the Saudi-led coalition fighting the Houthis in Yemen. This is expected to significantly disrupt Qatari trade, tourism, the banking sector, which is highly dependent on foreign funds, and, potentially, preparations for the FIFA World Cup.

Ratings agency S&P responded to the political developments by lowering Qatar's long-term rating by one notch to AA- and putting the country on negative watch. S&P believe that the above dispute could "exacerbate Qatar's external vulnerabilities and put pressure on economic growth and fiscal metrics".

Egypt: The PMI failed to show further improvement in economic activity in May, with the index mostly unchanged at 47.3. (Chart 2.) Amid the weakness, exports showed exceptional strength. Price pressures eased further as the bout of inflation which followed the currency float abated.

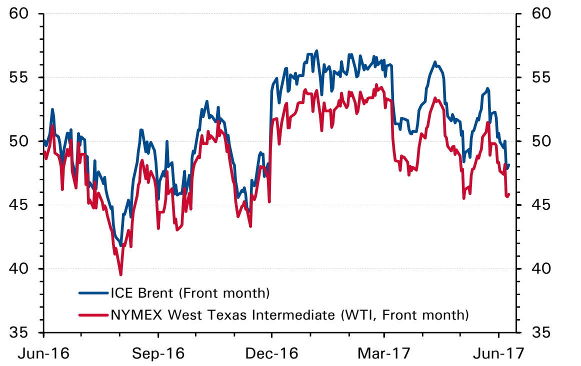
The CBE's reserves rose to their highest level in six years in May, adding $2.5 billion to $31.1 billion (equivalent to 7.7 months of imports). (Chart 3.)

Inflation eased in May to 29.7% y/y after peaking in April. The CBE had surprised analysts two weeks ago when it hiked policy rates by 200 bps to fight persistent inflation. May's price gain was steady from April, suggesting that the CBE may have been justified in its concern. (Chart 4.)

Egypt's decision to join its GCC allies in cutting ties with Qatar is likely to have little impact on the Egyptian economy. Some 250,000 Egyptians living in Qatar have not been asked to leave. While over 60% of LNG imports came from Qatar in 2016, this supply remains untouched. Authorities indicated that private Qatari investments in Egypt will not be affected, though Qatar accounts for only 1-2% of FDI inflows.

Chart 5: Crude oil prices

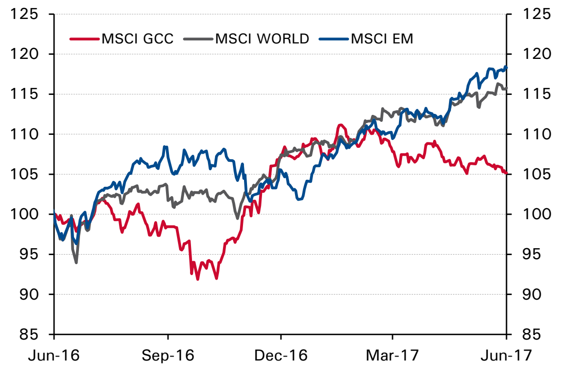
($/bbl)



Source: Thomson Reuters Datastream

Chart 6: Total return indices

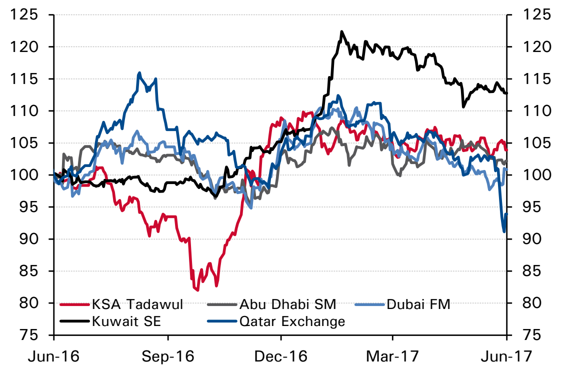
(rebased, 10 June, 2016=100)



Source: Thomson Reuters Datastream

Chart 7: GCC Markets

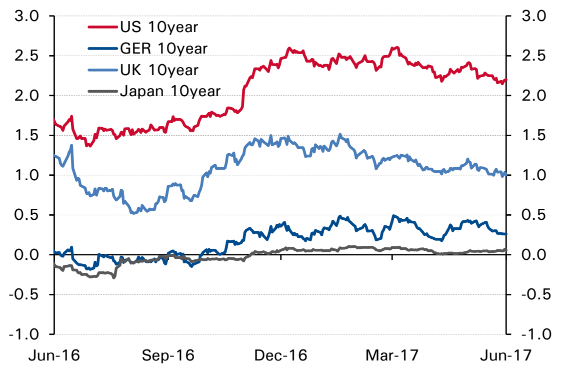
(rebased, 10 June, 2016=100)



Source: Thomson Reuters Datastream

Chart 8: Global bond yields

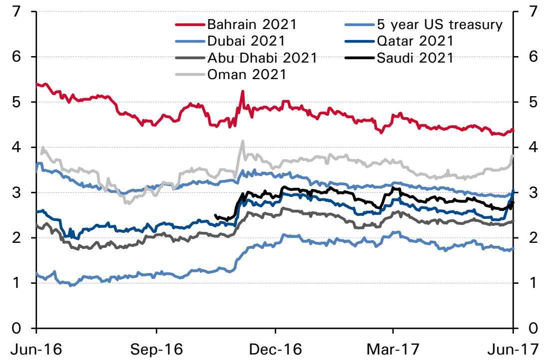
(%)



Source: Thomson Reuters Datastream

Chart 9: GCC bond yields

(%)



Source: Thomson Reuters Datastream

Markets – oil

Oil prices closed the week down for the third week in a row. Brent dropped 3.6% w/w to $48.15 while WTI fell by 4.9% w/w to 45.83. (Chart 5.) Both markers are at their lowest levels since last November, erasing all of the OPEC-orchestrated price increase of the last 7 months. Once again, US petroleum data was the culprit in the decline, with crude stocks rising, by 3.3 million barrels. These are counter-seasonal figures; the crude stock increase broke an 8-week declining trend, with gasoline and distillate stocks also increasing, which is somewhat surprising given that the summer period is usually associated with a drawdown in inventories. But—and this was completely ignored by the markets—US crude production actually declined, by 24,000 b/d to 9.32 mb/d, which is the first time that has happened since February.

Markets – equities

Equity markets were slightly down despite an eventful week and higher volatility. The MSCI World index closed the week down 0.4%. US stocks continued to make new highs despite all the negative attention surrounding the testimony of the former FBI Director. The S&P 500 retreated later on in the week and closed down 0.3% while the DJIA advanced 0.3%. European equities were slightly off on the week, with the Euro Stoxx 50 down 0.2%. Markets were holding off in the run-up to the UK elections and the ECB meeting later in the week, but didn't react much to the outcomes of either. Emerging markets outperformed, with the MSCI EM up 0.4% led by a strong performance of Chinese equities. (Chart 6.)

The political rift between Qatar and three gulf states and Egypt took center stage this week. The Qatari market was severely hit closing the week down 7.1% despite a strong bounce in its last trading session amid heavy Qatari institutional buying. Other GCC markets were little affected and mostly "flat" on the week. The MSCI GCC index was down 0.8%. Regional markets will continue to monitor closely how this political crisis develops. (Chart 7.)

Markets – fixed income

Global bond markets were muted for most of the week, trading within a narrow range. First was the ECB, which stood pat, but with a more optimistic outlook (GDP growth was revised up and forward guidance language was changed). Then came ex-FBI director James Comey's testimony. And finally, the UK election, which resulted in a hung parliament. All in all, this saw US and German yields see-saw tightly within a range of 2.16-2.20% for US 10-years and 0.26-0.30% for 10-year bunds. (Chart 8.)

GCC sovereign yields on bonds maturing in 2021 for Abu Dhabi and Dubai, and 2022 for Saudi were up between 5-10 bps this week on heightened geopolitical risk following the Qatar rift. Kuwait's 2022 bond also saw its yield increase by 4 bps, ending the week at 2.54%. (Chart 9.)

Economic risks for Qatar are elevated in the wake of its isolation by neighboring GCC states. As a result, S&P downgraded the sovereign to AA- from AA, with a negative outlook. Moody's had already downgraded Qatar to a similar level (Aa3) only a few weeks ago. Other side-effects include: increasing yields on Qatar 2021 and Qatar 2026 bonds, which are up by 60 bps and 40 bps on the week, respectively; and rising CDS (5-year) spreads, which are up 35 bps to 94bps.

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