NBK

International scene

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Markets get a small dose of realism

The first quarter of the year saw the January inauguration of a new US president, the unconventional Donald Trump, and the advent of a more "normal" or perhaps more "aggressive" Federal Reserve. The Fed also raised its target rates in March when the earlier expectation had been for June 2017. These events and others (including the disappointing performance of anti-establishment voices in the Dutch election) were taken in stride by most markets, and were in line with expectations. The markets were looking for rising equity markets, a rising USD, and higher US interest rates. That is more or less what they got, except for the USD, which continues to baffle many, and especially against major currencies.

In the case of Mr. Trump and his agenda for a friendlier business environment, the expected gains are many (deregulation, tax cuts, infrastructure spending), and stocks had a very strong run after the election of 8 November. By quarter's end (Q1), US stocks were up 13% (Dow Industrials) and 10% (S&P 500) since the US election and some 4-5% year-to-date (ytd).

Moreover, after a long stint of daily gains, US politics and the US legislative process finally caught up with markets late in Q1. Some (overdue) adjustment finally weighed in, primarily on the USD and US equities, especially after the Trump administration failed to secure enough support to pass its priority health care reform legislation. According to the broad consensus of late 2016, the USD was supposed to rise in 2017, at least in the first part of the year. That view was based on three arguments:

- The stronger US economy would imply a still tighter Fed policy stance, certainly relative to the eurozone and the ECB (and other countries).
- Trump's economic agenda would further pump up the US economy.
- Political and election risk in Europe would weigh on the euro and help the USD.

These three factors remain in play but appear to have been largely discounted already. Furthermore, expectations are turning less supportive of the USD, in all three cases. EU economic numbers are relatively solid, and the days of aggressive ECB easing action may well be numbered. In fact, the eurozone outgrew the US in 2016 for the first time since the financial crisis (1.7% to 1.6%, in the US, real GDP growth). On the second point, the agenda of Mr. Trump and the Republicans is indeed in the pipeline but the rosy view of a smooth and timely policy unfolding has bumped into reality: Congressional votes have to be rounded; different groups and factions need to be satisfied, parliamentary rules get in the way, etc.

Finally, point-three above was deflated by the results of the Dutch election. These saw the far-right party do well but underperform expectations. Now fresh French polls show support for the mainstream candidates, so far, for the April-May presidential election.

So, the USD, which always had an extremely difficult time breaking the 1.05 level to the euro, was trading above 1.08 recently (euro up 3% ytd). Similarly, the JPY had a good run and traded near 111, or up 5.5% ytd. Many analysts revised their USD numbers lower for 2017.

For the Fed and interest rates, US rates are up roughly 40-50 basis points (bps) since the two rate hikes of December 2016 and March 2017 (two 25 bp hikes of the federal funds target). The 10-year note is currently around 2.4% after flirting briefly with the 2.6% level. European levels are moving in the same direction, when not impacted by flight-to-quality. At the same time, their low yields (sub-50 bps for Bunds), as well as near zero-yield Japanese 10-year notes are preventing US rates from rising too fast or too far.

Like equities and the USD, US rates also corrected slightly late in the quarter, driven in part by the more realistic expectations for the Trump economic and tax agenda. Mr. Trump and the Republicans (currently with zero help from the Democrats) were intent on, in that order: repealing and replacing Obamacare, cutting taxes, and pushing infrastructure spending.

The first part, health care reform, has now been postponed, or scrapped, for lack of sufficient Congressional support. This should further weigh on expectations ahead. The US House of Representatives' failure to pass the American Health Care Act (ACHA, to replace Obamacare) was seen as a crucial first test of Mr. Trump's leadership in Washington and of his influence on his own party. Markets have thus turned more cautious in their anticipation of the other expected economic "goodies" (tax cuts, infrastructure spending) down the road.

Meanwhile, regional GCC economies are showing signs of growing moderately, led by Kuwait and Qatar and the UAE. Oil prices have helped finances and sentiment by spending a good deal of time near $55 per barrel. Prices were pressured lower more recently, by strong US (shale-led) production, now exceeding 9 million barrels per day. The major story in the region the past few months has been the massive issuance of sovereign debt, more recently by Kuwait ($8 billion) and Oman ($5 billion) in what were very successful issues (in terms of both interest and pricing). Following 4Q16 issuance, Saudi Arabia is now looking to issue international sovereign sukuk . These issues are also helping relieve any liquidity pressures in the GCC countries.

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