Entering the Honeymoon Phase

United States

The First three Presidential months

We take the opportunity to wish you a prosperous New Year 2017 full of health and happiness.

Before we dive into our weekly coverage and markets expectations for 2017, we cannot but turn our attention to the latest events in Asia.

The beginning of the year saw major fireworks in the currency markets from China where the offshore Renminbi rallied almost 2.8% the most on record after reaching almost seven to the Dollar. Having weakened 6.20% last year, the PBoC intervened this week by moving to strengthen the fixing in the onshore currency by the most since 2005 or since the Renminbi was de-pegged from the US Dollar. The catalyst for that earlier surge appears to be the crackdown by the PBoC on capital outflows at the end of last year. In addition, we saw lending rates in Hong Kong surging in recent days to reach extreme levels of 61% Friday morning and the second highest level on record in a thin liquidity environment, which helped exacerbate the moves.

Back to the macro environment, the major events of the end of 2016 all leaned towards a strong US Dollar environment. Whether the Fed delivering the rate hike; the negative response from the Italian referendum and last but not least the potential new US policies, the stars were aligned for a strong USD going into the yearend and the beginning of 2017.

In parallel, the last meeting of the FOMC took interest rates up by 25 bps and the ‘dot plot’ projections for 2017 showed three further rate hikes in 2017 up from the two hikes anticipated in September. The FOMC’s statement also acknowledged the strengthening economic activity and mentioned that measures of inflation compensation have moved up considerably even if remain low. The median forecast for US 2017 GDP growth was revised up to 2.1%, from 2.0%, while the unemployment rate forecast was revised down a small amount to 4.5%, from 4.6%.

This week, minutes of that FOMC meeting indicated that the Committee “emphasized their considerable uncertainty about the timing, size, and composition of any future fiscal and other economic policy initiatives as well as about how those polices might affect aggregate demand and supply. The tone was generally upbeat, but it did not contain any more additional hawkish hints since the release of the three-2017 rate hike Fed Funds dot plot. The view of the Committee still looks for a gradual tightening path going forward, with risks being broadly balanced although almost all of the members acknowledged upside risks to their US macro outlook. About half of the FOMC members have used more expansionary fiscal assumptions since Trump was elected, which may be at risk of a reality-check adjustment. On the other hand, some members cited caveats like a strong USD for the Fed to keep embracing a cautious stance, although this is a warning the market has been used to hearing since the Fed embarked on its tightening path. Yet, the dollar appreciation was viewed as a partial counterbalance to the upside fiscal policy risks, and the dollar was also mentioned as a factor limiting upside inflation risks. Overall, the discussion of the inflation outlook wasn’t a major point as per the minutes.

Moving on, during the last few years, the relationship between foreign exchange rates and interest rate differentials between currencies has provided the most accurate expectations when it comes to currencies movements. After ending 2016 with a bang following the dramatic move higher in US real yields relative to those elsewhere, markets have entered the New Year questioning the large US Dollar move post Trump election. Indeed, unlike the big expectations going into the recent US presidential election, 2017 starts with a reality check where markets start to wonder whether the Trump administration is going to be constrained by the realities of what's happening domestically in Washington and geopolitically around the world.

In summary, despite all uncertainties, it is important to note that in the next ten days, we enter the honeymoon phase of the new president whereby historical standards, the new president is perceived to be good for business confidence and will be good for the economy through policies that aim to lower taxes, increase spending, and reduce regulation.

Back to the foreign exchange front, the Euro remains under pressure hovering close to the lows of 2016. The end of the 2016 saw the ECB confusing markets by announcing a €20bn reduction in asset purchases to €60bn a month from April 2017 though at the same time extending the program to December 2017. Despite tapering the program, the

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council was able to deliver a dovish tone to keep the pressure on the currency and broadened the pool of eligible public assets by lowering the minimum remaining maturity from two to one year.

Despite the political risks in Europe being on the rise, the latest inflation figures are likely to give the ECB potential ammunition to further taper their QE program later on in the second quarter if economic data continue to come on the strong side. For now, the year starts with interest rates differentials remain in favor of the US dollar, as we are likely to see a continuation of the same pressure build up.

2016 being the year of GBP weakness as the UK voted to leave the EU and the Bank of England launched a fresh QE purchase program, the first quarter of 2017 should see a continuation of a relatively low confidence as investors remain in a waiting mode even with an absence of negative news.

On the commodities front; after recent strong gains, gold prices retraced by the end of the week weighed down by mixed US jobs data. Moreover with US equity markets hitting record high this week in the wake of the jobs release, the broad-based shift to risk-on investments undercut gold's performance.

Operating Under a Cloud of Uncertainty

This week's FOMC minutes reiterated Yellen's post-meeting statement last month where she said that the Fed is "operating under a cloud of uncertainty at the moment".

The minutes also revealed a shift of the debates to the potential new administration policies. According to the minutes, "almost all" officials made mention of upside risks to their growth forecasts as a result of prospects for more expansionary fiscal policies while interestingly "about half" of the Fed officials incorporated fiscal policy into their forecasts.

Moreover, the minutes acknowledged that "participants emphasized their considerable uncertainty about the timing, size and composition of any future fiscal and other economic policy initiatives as well as about how those policies might affect aggregate demand and supply". Officials also acknowledged that this "made it more challenging to communicate to the public about the likely path of the federal funds rate".

The minutes also acknowledged that the staff's forecasts for higher real GDP growth over the next few years "were substantially counterbalanced by the restraint from the higher assumed paths for longer-term interest rates and the foreign exchange value of the dollar".

On a different front, San Francisco Federal Reserve President John Williams said that "more fiscal stimulus will have a modest effect on economic growth over the next couple of years". Though Williams said he raised his predictions for fiscal stimulus under a Trump presidency, however his growth predictions remain lower than the major estimates. "My view, in terms of the demographic and productivity trends that we've been seeing for the last decade or so is that growth is likely to be 1.5 to 1.75% " Williams said.

US data continue to support the General state of the Economy

US auto sales rose for a seventh straight year in 2016, exceeding the2015 number. In December, sales rose at an annual rate of 18.4 million beyond economists' forecast for 17.7 million. The gain in December pushed the pace of sales last year up by 0.3% to a record 17.54 million cars and light trucks. Automakers sold 17.4 million vehicles in 2015. Sales last year were driven by lower gas prices, the high average vehicle age for cars on the road, easy credit, and incentives for buyers. Moreover, with interest rates on the rise the first time in almost 9 years, consumers rushed to take advantage of advantageous financing rates.

While this week's ADP data may have come in slightly disappointing, data out of the services sector was more upbeat. The services PMI was revised up at the final count to 53.9 in December from the earlier 53.4 flash reading. Meanwhile the ISM non-manufacturing print came in at 57.2 which, while unchanged versus November, was still better than the 56.8 expected. New orders component ticked up to 61.6 from 57.0. The remaining data was the latest weekly initial jobless reading which saw claims fall steeply to 235k from 263k.

Nonfarm Payroll Leading the Way for a Gradual Path of Monetary Tightening

December nonfarm payrolls rose 156,000, below expectations of 175,000, however the weakness was offset by gains in earnings. Average hourly earnings rose 0.4% against expectations of 0.3% and rebounding after the 0.1% drop in November. The year-on-year increase in average wages reached 2.9%, the highest since 2009. With Unemployment rate on the other hand rising to 4.7% from 4.6%, the current unemployment rate sits at the lower end of the Federal

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Reserve's 4.7% to 5.0% natural rate of unemployment. A continued decline in unemployment should persuade the FOMC that a gradual path of monetary tightening is still appropriate

Europe & UK

Reflation theme is well and alive in Europe

With Eurozone Flash CPI climbing above 1% for the first time since 2013, the reflation theme is well and truly alive in Europe. Indeed, the latest data showed this week that estimate of headline CPI had risen more than expected in December after coming at +1.1% against expectations of 1.0% from +0.6% in November. The data put headline inflation at the highest level since September 2013 and encouragingly while higher energy prices led, the increase was actually relatively broad based.

Moreover, PMI data were also out this week with the final composite PMI for the Euro area in December was revised up to 54.4 from 53.9 after the services reading was revised up 0.6 pts to 53.7. That is the highest PMI reading since 2011, just beating the 54.3 seen in August and December 2015. A number of the sub-indices at the same time including the composite input and output prices and new orders, were confirmed at new cyclical highs. Across countries the news was broadly positive across the EMU countries while Italy was the relative disappointment with the composite down 0.5 pts to 52.9, although this came after a 2.2 point rise in November.

Germany to the ECB: Time to End QE

The head of the German Ifo Institute said in an interview this week that the ECB should end QE should the pick-up in inflation witnessed in Germany also be seen elsewhere in the Eurozone. In this case “there would then be no further justification for a continuation of purchases. The jump in inflation is a signal for the ECB to exit its expansive monetary policy” he said.

Despite the good news, Investors continue to shun the UK

According to Bank of England Chief Economist Andy Haldane, U.K. consumers could cut on spending as inflation accelerates in 2017. “This year might be a somewhat more difficult year for the consumer,” Haldane said this week. “We’ve had a hefty fall in the exchange rate, the effects of which on prices in the shops is beginning to trickle through. That will in turn produce something of a squeeze on the spending power of consumers, and may lead them to throttle back somewhat in their spending plans.”

Since Britain’s vote to leave the European Union in June, Households have kept up spending fueled by increased borrowing. That turned into stronger economic growth than many anticipated in the second half of 2016, though the BOE sees slower expansion this year.

For a while, the Sterling Pound has been trapped between valuation attractiveness and the Brexit uncertainty. Although the latest economic data remain supportive and real yields in the negative due to the high inflation resulting from the rapid depreciation of the currency, investors remain on the sideline when it comes to taking a view on the state of the country.

The positive news is that 2016 has ended on an upbeat political stance allowing the Pound to recover after the parliament backed a motion calling on the government to set out its Brexit plan and activate Article 50 before the end of the first quarter of 2017. The vote marked the first time that MPs have endorsed May's Brexit timetable signaling an end to the clash between the government and the MPs.

Now that the overly negative sentiment has lost momentum, Sterling volatility has fallen but remains relatively high while Prime Minister May has shown recently a more resilient stance aimed to reduce the uncertainty felt in the business community and could potentially signal a soft Brexit form the European Union.

In summary, the latest events of 2016 whether on the European front with the Italian referendum or the political transition of the US presidency, have put the “Brexit” on the back burner for now. Regardless, UK business and political uncertainties remain high and aren’t likely to dissipate in anticipation of a potential loss of EMU market access. In addition, Brexit negotiations are likely to take a long time to unfold, making it difficult for investors to turn positive on the currency.

Asia

One off Devaluation Could be the Answer for China

According to the forecasting department at State Information Center (SIC), China's economic growth could slow to 6.5% this year from about 6.7% in 2016, while suggesting a one-off devaluation could help stabilize the yuan currency. Moreover, the momentum from new technology would continue to stimulate economic growth but could not stop the broader slowing trend. Industrial output could grow 5.9% this year, down from an estimated 6.1% in 2016, it said.
In parallel, authorities should increase the role of the market in formation of the yuan exchange rate, increase the currency's flexibility "and even conduct a one-off devaluation of the renminbi, and thereby maintain renminbi stability at a balanced level," it said.

China's last one-off currency devaluation in August 2015, shocked markets and was widely negatively viewed by the market. With the Yuan almost reaching the 7 level against the USD and capital outflows steadily eroding China's forex reserves, analysts `have discussed the possibility of a second devaluation, but there has been little indication that policymakers were considering such a move.

Kuroda Confident in Fighting Deflation

Japan's services sector expanded in December to a seasonally adjusted 52.3 in December from 51.8 in November. The index remained above the 50 threshold that separates expansion from contraction for the third consecutive month, and rose to its highest since January 2016. New business expanded at the fastest rate since July 2015. December was the fifth straight month in which new business increased.

Moreover, Japan Manufacturing PMI rose to 52.4 in December from 51.3 in November, recording the highest reading since December 2015. Bank of Japan Governor Kuroda reacted by saying the economy is at a critical point to end deflation and that he is more confident will make progress in 2017 on deflation. He added that the BoJ will continue its easing programme.

Kuwait

Kuwaiti Dinar at 0.30585

The USDKWD opened at 0.30585 on Sunday morning.

Rates – 08th January, 2016

	Previous Week Levels				This Week's Expected Range		3-Month
Currencies	Open	Low	High	Close	Minimum	Maximum	Forward
EUR	1.0517	1.0341	1.0620	1.0532	1.0340	1.0650	1.0595
GBP	1.2340	1.2200	1.2432	1.2340	1.2110	1.2435	1.2330
JPY	116.96	115.07	118.60	117.02	115.05	118.65	116.65
CHF	1.0190	1.0087	1.0335	1.0190	1.0060	1.0330	1.0139

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