International scene

Central banks finally nudge positions, impacting currencies and interest rates

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Midyear, things are proceeding more or less as was expected back in January. Economic growth is holding up well in most economies. Politics are not much of an impediment, though risk factors remain in the background and may be rising. Brexit negotiations are still a question mark, primarily for the UK. Qatar's dispute with its neighbors is a factor certainly for some GCC equities.

More importantly, the Trump agenda on tax cuts and economic stimulus remains an expected plus for US equities, even if not for this year. However, as we approach the US Congressional mid-term elections of November 2018, the markets will want to see concrete action, surely for reasons economic but also to avoid a Republican setback in the election. The latter would likely be seen as delaying, or even derailing, the current pro-business agenda. US politics are bound also to loom larger, because the above will be taking place against a backdrop of a US Federal Reserve raising interest rates further and embarking on the next leg of undoing years of quantitative easing.

The Fed recently signaled strongly that it intends to start reducing the size of the massive portfolio, which was amassed over several bouts of quantitative easing since 2008. The portfolio today stands at $4.3 trillion (Treasuries, Agencies and mortgage-backed securities) versus under $1 trillion prior to 2008. The wind-down will be very slow and gradual, starting probably in September 2017 and in amount of $10 billion per month initially. Still the Fed and the markets will want to see and reassure themselves that the unwinding of the unprecedented QE(s) will not cause undue market or other disruptions. Chair Fed Janet Yellen seemed confident recently that reducing the balance sheet gradually would have minimal/spread-out impact on long-term rates.

Furthermore, if one takes Fed rhetoric at face value (and the latest dot-plots), the Fed should be hiking the federal funds rate once more this year (25 bps), and about 3 times in 2018. The markets, and we, do not share that view at this point, in large part because US inflation, as well as EU inflation, continues to disappoint on the lower side of their 2.0% targets.

The world economy is still expected to grow at 3%-plus this year, with US GDP growth above 2.0%, EU close to 1.5%, while China should maintain 6.5% growth. The last data from the US is consistent with this outlook; June payroll employment added 222K new jobs, unemployment was little changed at a low 4.4%, and wage growth remains tame, with steady y/y rises of 2.4%.

The uncertainty around the Trump agenda and the strength of the economic recovery are the other factors generating market doubts for the US interest rate forecast ahead. The markets seem to be looking for just one 25 bps in the next 12 months, to June 2018, and that with about 50% probability. While at the same time, the signs from other major central banks, in particular the ECB, have pointed to the end of aggressive accommodation soon, and to the possible tapering of bond purchases perhaps by end of year.

The result has been a gradual rise in short-term interest rates, with the US 2-year reaching a yield of 140 bps for the first time since 2008. The longer maturities, which remain very well behaved, have seen their rate rises contained thanks to low inflation and repressed European yields. However, long rates are finally seeing some upward pressure from signs of the Fed unwinding its balance sheet, as well as from finally higher European rates. The latter were freed up by signs that the ECB was about to "taper" or stop its purchases in 2018. 10-year US rates rose to 2.38% recently, while German 10-year Bunds jumped to 0.58% after starting the year at 0.18%. Nonetheless, rises in long rates are still expected to be gradual thanks to a gradualist Fed and ECB, when its time comes, as well as low inflation. In fact, US rates fell slightly since, following Janet Yellen's recent dovish comments on inflation.

Inflation is contained and below target and the recent downward pressure on oil prices means another bout of soft inflation data. Oil prices in fact were the main surprise or deviation from expectations earlier this year. Oil prices remain under pressure, notwithstanding an extension by OPEC and its partners of the earlier production cuts into 2018. Oil prices are off 14% from the start of the year, and Brent is well below $50 pb. With the OPEC production cuts acting slowly on supply, and with still rising US production (primarily from shale oil), the market has had a very difficult time getting to balance. Balance was expected by mid-year but now seem pushed to 2H2017, if not next year.

This prospect has pressured GCC equity markets, or at least prevented them from doing better. At the same time, the diplomatic row between Qatar and three GCC members (Saudi, the UAE, Bahrain plus Egypt) has also unsettled some investors. These are some of the factors responsible for the year-to-date underperformance of the regional markets, versus international markets. Saudi was helped, to a large extent, by its consideration and potential future inclusion in the MSCI emerging market index, which was announced in June.

The change in relative central bank positions has also pressured the USD recently, in particular versus a rising euro. The USD is off 8.4% against the euro, and 2.6% against the yen. As mentioned above, equities are performing well generally. The US headline markets are up close to 8% ytd, while in Europe the DAX (Germany) is up 7.9% on the year. Moderate growth, low inflation and slowly rising interest rates (toward "normalization") seem to be working nicely for equities, though valuations are getting rich in some markets and raising eyebrows in some investor and policy circles (BIS, Fed...).

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