

International scene

The Fed set to move, growth and inflation data firmer all around

US equity markets keep grinding higher and breaking record highs, almost on a daily basis. They are doing so in a gradual and orderly fashion, supporting along the way many of their counterparts, including in Europe and in the GCC. The background is twofold: solid economic data in the US and in the EU, and the advent of the Trump administration. Away from the hoopla in the non-financial media and the circus atmosphere in some cases, price action and financial commentary strongly suggest that the markets assess the Trump election to be a seismic game changer, obviously on the positive side. The concerns are certainly there, especially when it comes to international trade. Nonetheless, for now, the markets and the administration are primarily focused on the clear pluses of the Trump administration: tax reform and deregulation.

The markets were further emboldened in the first Trump days by swift action on, among others, deregulation: a freeze on new regulations and federal hiring, intent to reduce regulations by 75% over time, re-authorizing two large pipeline projects.... These and other actions and announcements boosted both consumer and business sentiment, and have everyone talking about revived "animal spirits". The administration is playing it smartly by leaving trade issues (and a potential border tax) for later. We think that many of Mr. Trump's trade positions may moderate over time, especially if other aspects of his agenda are implemented successfully and buoy the markets and the economy.

On many parts of the new administration's policy, details are lacking, which is normal in the first month or two, but as we go forward the markets will come to demand more clarity. In his first formal address to Congress on 28 February, Mr. Trump gave some broad policy lines but the fiscal details (taxes, spending) remain to be filled later. The Republicans and Mr. Trump are planning to tackle healthcare/Obamacare reform first and that may take some time, and some details there were unveiled during the speech. Treasury Secretary Mnuchin had earlier mentioned that the new tax legislation may see the light by August of this year. The upcoming business-friendly legislation is expected to include a tax cut for businesses and the middle class, along with tax simplification, though a border adjustment tax (BAT) and the law's deficit implications may prove quite tricky and may temper some of the enthusiasm. The speech was well received politically and by the markets, where equities soared the next day, and the Dow Jones Industrials broke 21000 for the first time ever.

The economic environment has also been supportive in general, and it now appears that the Fed will be hiking interest rates this month by 25 bps. The US and eurozone grew 1.6% and 1.7%, respectively, last year; there are also encouraging signs from PMIs and other data going into 2017. China grew 6.7% in 2016. The eurozone manufacturing PMI was 55.4 for February, the strongest in six years, and a steady 55.5 for services. China's manufacturing sector continues to

expand with a pickup in export orders, as shown by the Caixin PMI survey for February; the index rose to 51.7 from 51.0 in January. February CPI inflation from the eurozone was at 2.0% y/y in February, the highest in four years. All these data were in line with expectations of moderate world growth, and, further, are supportive of oil and other commodity prices. Those markets as well as FX and fixed-income markets saw little change since the beginning of the year. In light of all that, the Fed has been making more hawkish noises, not least confirmed by Fed Chair Yellen, upping the ante for a now likely 15 March interest rate hike. Barring an unlikely surprise, we believe the 10 March US employment (and wages) report will seal the fate of that move by the FOMC. Having just moved 25 bps in December 2016, the Fed appeared held back by the uncertainty regarding Mr. Trump's new policies and by potential political disruptions in Europe. However, these factors have abated to an acceptable level, for now, and the data on growth and inflation fully support an imminent rate hike.

Europe faces three important elections starting with the Dutch (in March) and the French (April-May). These factors have helped keep interest rates low in core Europe (except for France), and the euro lower than perhaps otherwise. In the case of France, Marine Le Pen (National Front) is the leading presidential contender in the first round but is not expected to be elected in round two. Nevertheless, she and her party are advocating getting France out of the euro (re-denominating French bonds in a new national currency), and out of the EU, which of course weighed on French markets. For Europe's economy in general, the PMI numbers have been quite positive (including for France) and the inflation data has firmed. Without the political caution, these factors would have likely pushed rates higher already.

Barring significant politically induced volatility, in US and/or Europe, the Fed should be poised to raise its target federal funds rate twice this year (including March), perhaps more. That much is expected by the markets, and the GCC countries are expected to follow suit. The GCC markets have in general done well since Q4, led by Kuwait, though some recent Q4 earnings have been mixed. February PMIs from the UAE and Saudi continue to support modest/moderate growth in the region. And still, the perception is one of renewed interest in those markets (domestic and international), buoyed by recent economic reforms and plans, and the fact that oil prices have held up well above \$55 per barrel (Brent). Fixed-income markets are also perking up interest, with many sovereigns issuing or announcing upcoming bond issuance: Bahrain in February, KSA, Dubai, Oman and Kuwait in the pipeline.

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