Weekly Market Summary

17th of June 2016

Messy and Irrational Markets....Perfect Time to Plan a Summer Holiday!!

Fadi Nasser (SVP – Head of Treasury Sales)

Markets and risk sentiment continue being dominated by the fast approaching referendum on UK membership in the EU, planned for June 23rd. In past week, polls have shown a notable momentum and lead (anywhere between 4% to 10%) for the "Leave" campaign, prompting the US Federal Reserve, UK Bank of England (BOE) and the IMF to step in and confirm that a UK vote for exit of the EU in less than a week would "*precipitate a protracted period of heightened uncertainty, financial market volatility and slower growth as the U.K. negotiates its new relationship with the EU*", and add that the severe "*damage could extend to global markets and the world economy*".

Anxiety about next Thursday's "*knife-edge*" referendum had recently spread to all financial asset classes, with the UK pound, stocks and commodity markets coming under severe pressure, whilst government bonds remain in high demand (my theory about the "flight to safety" of bankrupt governments' papers!). Recurring economic and geopolitical uncertainties are driving traders to bid up global sovereign debt even as yields fall to record lows and as over US$ 8 trillion of government securities yield less than ZERO! Investors who buy bonds with negative yields are not just willing to lose money as they seek safe havens, but they are also hoping there will always be another trader ready to buy at a higher price (in other words, to make money in today's bond market, one has to keep finding the greater fool -- a la investment in the NASDAQ in 1999/2000 and rush into US Real Estate in 2005/2006!).

Yields have plunged as most central banks hold rates near zero and maintain or boost bond-buying stimulus programs (this year, the ECB also incorporated corporate debt into its bond-buying strategy, adding another potential buyer to the market for company securities). Japanese, German, UK and Swiss bond yields have fallen to record lows as government debt around the world extends its best start to a year in more than two decades. Demand for sovereign bonds also rose after the Federal Reserve on Wednesday held rates steady and lowered its projections for the path of policy tightening over coming years (the Bank of Japan on Thursday also kept monetary policy unchanged, despite market expectations for additional stimulative measures). As a result, 10-year US Treasuries traded to a low of 1.515% yesterday, whilst 10-year German and Japanese bond yields touched -0.04% and -0.21% respectively, both record lows.

This morning, risk appetite has returned in the Asian and European sessions, with equity markets and oil trading higher, while bond prices push lower (higher yields). The GBP and EUR have reversed previous day losses and rallied 1.6% and 1.2% respectively (GBP/USD and EUR/USD last at 1.4270 and 1.1250) , as campaigning for the UK referendum gets suspended for a second day following the tragic murder of British MP (Jo Cox) yesterday (unfortunately, FX markets do not show respect for the dead and cease trading!). In addition, a bookmaker-implied probability of a "Leave" vote fell to 38% after surpassing 44% yesterday (Oddschecker).

The general feeling in markets this morning (rightly or wrongly?!) is that the recent momentum of the "Leave" campaign could weaken as a result of the interruption. Additionally, the murder may have been politically motivated (eye witnesses reporting that the killer shouted "Britain First"), and if true would create sympathy for the "Remain" camp. Other analysts argue that the recent agreement between 5 major central banks to provide unlimited emergency dollar funding in case markets are disrupted or credit seizes up after a Brexit vote (according to Reuters sources) has reassured traders that future market disruptions would be avoided and resulted in swift "risk-on" bets.

Going back to Wednesday's Fed meeting and ensuing press conference by Fed Chair Janet Yellen, the US Federal Reserve has all but ruled out a summer interest rate rise as officials lowered their growth forecasts and said improvements in the jobs market had "*slowed*". Yellen also warned that a British exit from the EU could have "*consequences for economic and financial conditions in global financial markets*" that could keep US interest rates lower for longer. *"The EU referendum is clearly a very important decision for the UK and Europe*," she said. "*It is also a decision that could have consequences for the US economic outlook and that would be a factor in deciding policy*." Official projections released alongside the Fed unchanged decision showed fewer policymakers now expect the central bank to raise interest rates more than once this year. Policymakers also expect a slower pace of hikes over the next three years (new Fed's projections show policymakers still foresee two rates hikes in 2016, but now predict just three rate hikes for both 2017 and 2018, down from an expectation of four per year at the March 16th FOMC). Whilst Ms. Yellen acknowledged that every upcoming Fed meeting remains a "live" one, and noted that a rate hike at the next FOMC meeting on July 27th was "*not impossible*" - if data showed that the recent plunge in US jobs growth was an "*aberration*" - she also stressed that policymakers wanted to see "*sufficient economic momentum*" before tightening policy.

The Fed's latest decision came as no surprise to markets, given heightened market worries surrounding next Thursday's UK referendum. Still, I must point out that US central bankers have been very successful in employing a list of excuses to justify zero interest rates over the past few years: From high US unemployment rate to weak global growth (valid reasons), a shaky financial system, the Greek debt crisis, war in Ukraine, terrorist threats in the Middle East and globally, depressed commodity prices, low US labor force participation, sharp drop in equity markets earlier this year and now uncertainty over Britain's exit from the European Union and a one-month blip in job numbers!!

Nonetheless, giving the patient more medicine (zero rates) after a long period of healing will NOT do much good! Even worse, administering more medicine is actually harmful because the patient is now addicted to it. And it is not just the Fed that has been administering the monetary stimulus, as other major central banks - including the Bank of Japan (BOJ), Britain's BOE and in the last few years the European Central Bank (ECB) - have all joined the "money printing" party, and flooded markets with so much cash that has badly distorted the price of financial assets (specifically fixed-income markets) relative to the price of everything else. With the U.S. economy nearly back to full employment, US incomes rising and core inflation running close to 2%, it is well past the time to start easing back on the stimulus by raising rates to a more normal range (somewhere between 2.00% and 2.50%). And honestly, it is not as Yellen said on Wednesday, an abundance of caution that keeps the Fed from beginning to withdraw monetary stimulus, but simply a lack of courage - the courage to stand up to financial markets and the courage to force business and political leaders to finally deal with the economy's underlying problems (***Such a strong sense of déjà vu!****)*.

Disclaimer

It is important that you only use this report if you are the intended recipient of this report and you have satisfied yourself that you are eligible to receive such information. This report is provided to you because you are one of our esteemed customers and have previously shown interest in receiving the type of information contained in this report.

The Treasury and Investment Management department of Gulf International Bank B.S.C. ("GIB") have compiled the information in this report. GIB is incorporated in the Kingdom of Bahrain and is licensed by the Central Bank of Bahrain (the "CBB") as a conventional wholesale bank. GIB's head office is located at Al-Dowali Building, P.O. Box 1017, 3 Palace Avenue, Manama, Kingdom of Bahrain.

This report is intended for the accredited investors, as defined in the Investment Business Code of Conduct published by the CBB. This information has not been reviewed by the CBB or any other regulatory authority in any jurisdiction and neither CBB nor any other regulatory takes any responsibility for the correctness or accuracy for the information contained in this report.

The information contained herein is not directed at or intended for use by any person resident or located in any jurisdiction where (1) the distribution of such information is contrary to the laws of such jurisdiction or (2) such distribution is prohibited without obtaining the necessary licenses or authorizations by the relevant branch, subsidiary or affiliate office of GIB and such licenses or authorizations have not been obtained. The recipient of such information is responsible for ensuring that this information has not been received by it in breach of laws and regulations of any jurisdiction.

This report contains publicly available information only, which has only been complied by GIB. The information provided herein is on "as is" and "as available" basis and without representation or warranty of any kind. GIB hereby disclaims any representation or warranty, express or implied, as to the accuracy, timeliness, completeness, merchantability, fitness for any particular purpose or non-infringement of any of such information. In no event shall GIB or its subsidiaries, affiliates, shareholders or their directors, officers, employees, independent contractors, agents and representatives (collectively, "GIB Representatives") be liable (1) for any inaccuracy, delay, loss of data, interruption in service, error or omission or for any damages resulting there from, or (2) for any direct, indirect, incidental, special, compensatory or consequential damages arising from any use of information or arising from any error (negligent or otherwise) or other circumstance or contingency within or outside the control of GIB or any GIB Representative, in connection with or related to obtaining, collecting, compiling, analyzing, interpreting, communicating, publishing or delivering any such information. The information here is, and must be construed solely as, compilation of information (unless expressly stated otherwise) and not statements of fact as to credit worthiness or recommendations or opinions of GIB.

This report does not provide individually tailored investment advice. Any materials contained herein have no regard to the specific investment objectives, financial situation or particular needs of any specific recipient. The document is provided for information purposes and is not to be construed as a solicitation or an offer to buy or sell any securities or related financial instruments. GIB makes every effort to use reliable, comprehensive information, but we do not represent that it is accurate or complete. No representation or warranty, either express or implied, is provided in relation to the accuracy, completeness or reliability of the materials, nor are they a complete statement of the securities, markets or developments referred to herein. Recipients should not regard the materials as a substitute for the exercise of their own judgement. Any opinions are subject to change without notice and may differ or be contrary to opinions expressed by other business areas or groups of GIB as a result of using different assumptions and criteria. GIB is not under any obligation to update or keep current the information contained herein.

The value of, and income from, your investments may vary because of changes in interest rates or foreign exchange rates, securities prices or market indexes, operational or financial conditions of companies or other factors. Past performance is not necessarily a guide to future performance. Estimates of future performance are based on assumptions that may not be realised.

The information contained in this report is just for informational purposes. Information does not constitute a solicitation, an offer, or a recommendation to buy or sell any investment instruments, to effect any transactions, or to conclude any legal act of any kind whatsoever. GIB does not intend to provide investment, legal or tax advice through this report and does not represent that any securities or services discussed are suitable for any investor. When making a decision about your investments and business, you should seek the advice of professional advisors.

The report may contain statements that constitute "forward looking statements". While these forward looking statements may represent GIB's judgment and future expectations, a number of risks, uncertainties and other important factors could cause actual developments and results to differ materially from GIB's expectations. GIB is under no obligation to (and expressly disclaims any such obligation to) update or alter its forward-looking statements whether as a result of new information, future events, or otherwise. The historical information is provided for information purposes only. Performance figures are calculated before tax (if any) and after deducting ongoing fees and expenses. The performance figures are historical and past performance is not necessarily an indication of future results. Certain amounts (including %ages) included in this document may have been subject to rounding adjustments. Accordingly, figures may not be an exact arithmetic aggregation of the figures to which they relate. The values and forecasts shown represent our current indicative valuations and forecasts of the relevant transactions, currencies, interest rates, commodities or securities as at the date shown. Any value or forecast shown herein is not an indicative price quotation. We expressly disclaim any responsibility for the accuracy of the values or forecasts shown, any errors or omissions in the report

With the exception of information regarding GIB and save as otherwise specifically indicated, the information set out in this report is based on public information. We have, where possible, indicated the primary source of information. We strongly recommend the recipients consult the primary source of information. Facts and views in this report have not been reviewed by, and may not reflect information known to, professionals in other GIB business areas.

This Report, and the information contained herein (save to the extent that such information is publicly available) is confidential and may not be disclosed by you to any other person outside of your organization without our consent.

GIB retains all right, title and interest (including copyrights, trademarks, patents, as well as any other intellectual property or other right) in all information and content (including all text, data, graphics and logos) in this document. All recipients must not, without limitation, modify, copy, transmit, distribute, display, perform, reproduce, publish, license, frame, create derivative works from, transfer or otherwise use in any other way for commercial or public purposes in whole or in part any information, text, graphics, images from this document (excluding publicly available information) without the prior written permission of GIB.