Weekly Market Summary

8th of April 2016

When Global Markets No Longer Obey Economic Common Sense!!
Fadi Nasser (SVP – Head of Treasury Sales)

One of the oddest things about 2016, so far at least, is how economic common sense is being twisted in all sorts of ways to explain what is going on in the global economy and financial markets!

Take for example the release of the FOMC minutes (for the March 16th Fed meeting) on Wednesday that continues to reverberate in the global markets, and has so far led to large swings in equity, commodity and bond prices. Prior to the release, markets were divided as to how dovish or hawkish the Fed really is, and the Fed minutes did nothing to dispel this intense debate. The dovish leaning Fed officials remained dovish and the hawkish leaning Fed officials remained hawkish. However, the one major difference is that finally the U.S. Federal Reserve has acknowledged the fact that conditions overseas warrant a lot of caution going forward - although they did use the tired and old line of remaining data dependent. "*Several participants expressed the view that the underlying factors abroad that led to a sharp, though temporary, deterioration in global financial conditions earlier this year had not been fully resolved and thus posed downside risks*". As result many officials expressed "*that a cautious approach to raising rates would be prudent or noted their concern that raising the target range as soon as April would signal a sense of urgency they did not think appropriate*".

With that said, markets were hardly pricing any probability for a rate hike at the April 27th FOMC meeting and less than 30% chance of a rate hike at the June 15th meeting (the Fed funds rate fully prices a 25 bps hike from current levels only after **June 2017** , which is a critical observation to all our valuable clients who are reluctant to hedge their floating rate liabilities because they don't foresee the Fed hiking rates more than once or twice this year!); Which means that all in all, one can confidently assert that the minutes were a non-event no matter what the under-invested bulls and the perennial dark-siders might have you believe! The Fed was always going to move slowly on interest rates this year, if at all, despite the constant flip flop we hear almost daily from the various regional Fed presidents. Still, market reaction to the minutes was intense: Bond markets surged (yields down by another 6-9 bps this week), commodities rallied, the USD weakened sharply and stock markets sold off (partially reversing the most hated rally in the history of the stock market!).

And then there is the ever-strengthening Japanese yen?!

On January 29th, Bank of Japan Governor Haruhiko surprised investors by adopting a negative interest-rate strategy to encourage banks to lend in the face of a weakening economy rather than save the cash they receive in exchange for their Japanese Bonds (JGB) holdings. Also, the central bank delayed the timing of reaching the 2% price target to around the six months starting in April 2017, the third postponement in less than a year. Back then, we - as well as the rest of the market - felt the latest BOJ measures were purely aimed at cheapening the Japanese Yen. Indeed, the

latter dropped markedly following the BOJ announcement, trading to a high of 121.87 against the dollar. Japanese stocks zigzagged, rallying for 28 minutes, then falling sharply only to rise again as traders digested the news.

However soon afterwards, the market rudely rejected the BOJ approach and the Japanese currency started sharply strengthening against peers – rallying from 121.00 to 108.00 against the US Dollar in a matter of few weeks! This sharp rise in the Japanese yen against the U.S. dollar has puzzled strategists and traders who once thought the US greenback would break out this year as the Federal Reserve prepares to raise interest rates. But fears about global growth have dampened that reasoning - for now at least. And instead of weakening, the yen and other so-called "safe haven" assets have strengthened even as risky assets including stocks and commodities recently crawled off their recent lows. The involvement of speculators also appears to be a major factor driving the latest foreign exchange moves: Data from the Commodity Futures Trading Commission released last Friday showed that the net-long position in the yen among non-commercial traders rose to US$6 billion in the week ended March 29th, the largest long position for the yen since 2012, before Abe's election. And to make things worse, Japanese officials have in past days given traders one more reason to bet against the currency signaling that they have no intention to intervene in the market by selling large quantities of yen to try and weaken their currency. Both Prime Minister Shinzo Abe and Bank of Japan Governor Haruhiko Kuroda spoke out against intervention this week and Tachibana Keiichiro - a prominent member of Abe's Liberal Democratic party – added on Wednesday that Japan's economy could tolerate yen strength up to ¥100 to the dollar.

But what about the Shanghai so-called "*secret*" meeting?

The main meeting of the G-20 finance ministers and central bank governors that took place in Shanghai on February 26th was no secret. It was conducted with much fanfare and publicity. Thousands of reporters descended on Shanghai to cover the proceedings. However, it is believed that a side meeting of a core group consisting of the U.S., Europe, Japan, China and the IMF was kept under the radar. And believe you me this group really calls the shots! (another sad conspiracy theory L ?!).

The U.S., Europe, Japan and China together represent over 70% of global GDP. The IMF is believed to act as a kind of facilitator for these regular secret meetings, and an "enforcer" for whatever agreements are reached behind closed doors. The outcome of this undisclosed side meeting was possibly the biggest dollar take-down operation since the famous Plaza Accord of 1985 (as a reminder, the Plaza Accord was orchestrated by James Baker, who was Ronald Reagan's secretary of the Treasury at the time. The dollar had increased almost 50% between 1980–1985, reaching an all-time high that year. It was hurting U.S. exports and jobs and hence coordinated action was needed. The Plaza Accord was an organized effort by the U.S., France, West Germany, Japan and the U.K. to weaken the dollar: It worked, with the US dollar falling 30% over the next three years. The U.S. economy got a second wind, and the long Reagan-Bush expansion continued).

This time around, it all started with China's shock devaluation of the yuan last August. Because China had not properly managed market expectations, this shock destabilized the global financial system while IMF and Fed officials were quite upset that China was not playing by the rules of the game. However China did not care much about the rules because its economy was sinking under bad debts and capital outflows. China was after all acting in its best interests regardless of the global impact. With this background, the G-20 central bankers and finance ministers agreed that China needed help. After all it is the world's second-largest economy and it was falling fast. There was some danger it could take the world down with it. But further yuan devaluation was not possible (in the short run) because it was too destabilizing to markets.

Hence, the agreed solution was to weaken the yuan on a *relative* basis by strengthening the currencies of China's major trading partners, Japan and Europe. In other words, if the yen and euro could get stronger, that would be the same as making the yuan weaker, but without the shock of Chinese devaluation.

Since this secret deal was worked out on February 26th, the first chance the central bankers had to put their plan into action was mid-March. The ECB met first on March 10th, and was followed by the Bank of Japan meeting on March 15th and the Fed gathering on March 16th. All three central banks would be able to implement the secret plan in just five business days. Now it was "*game on*" for the biggest currency manipulation since 1985. Yet how could Japan and Europe tighten without explicitly raising rates? They did it by raising expectations: Markets thought Draghi's ECB "bazooka" would be long lasting, and expected Kuroda of the Bank of Japan to do more aggressive QE. In fact, Draghi did the minimum necessary, and then said he was done doing more, while Kuroda did nothing. Both decisions acted like tightening relative to expectations, especially when such decisions were followed few days later by the Fed announcement that it was in no rush to raise US interest rates anytime soon. The euro and yen went up against the dollar immediately. Comparatively, the yuan went down with no explicit devaluation by China. This was simply the new Shanghai Accord in action!!

Enough conspiracy theory for a Friday afternoon!! … How about adding a little context? How does the recent stretch of yen strength stack up over its history? The yen has been stronger before, of course. That is cold comfort to policy makers navigating a touchy economy right now and for traders burned by wrong assumptions about dollar/yen. And while the JPY has soared more than 10% against its U.S. rival since the beginning of the year, pushing through levels not seen since October 2014, the yen remains far below a post-World War II high reached in 2011, when it took just 75 yen to buy a dollar.

Going forward, I am of the view that the momentum of the JPY and US bonds appreciation, equity, commodity and USD depreciation will soon ease from here. This morning's correction in markets could be a first indication. Still, it is quite obvious that financial markets no longer know what is good or bad for them – so how can they know who to blame when things go wrong ???

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.