Weekly Market Summary

29th of Jan. 2016

Will Cracks Finally Start to Emerge in Asset Classes Correlation??

Fadi Nasser (SVP – Head of Treasury Sales)

Just when I thought I had little to cover this week in terms of new market developments (after all, most economic pieces released since the start of 2016 have been quite analogous and mostly devoted to the sharp drop in commodity and equity markets – a regular and unfortunate recurrence!), Bank of Japan Governor Haruhiko surprised investors this morning 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 received in exchange for their Japanese Bonds (JGB) holdings (in reality, the measure is purely aimed at cheapening the Japanese Yen!). 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. The bank now sees inflation rising 0.8% in the 12 months starting this April, down from a previous forecast of 1.4% (I still can't figure out the authorities' fixation towards creating much higher inflation at a time wages are hardly improving!).

The move to penalize a portion of banks' reserves complements the Bank of Japan (BOJ) record asset-purchase program, including 80 trillion yen ($666 billion) a year in government-bond purchases, which was kept unchanged at the board meeting. By a 5-4 vote, Kuroda led his colleagues to introduce a rate of minus 0.1% on certain excess holdings of cash, a measure that will take effect on February 16th. The BOJ latest announcement was hours after government reports showed the Japanese economy was unexpectedly weak in December, with bigger-than-anticipated declines in industrial production and household spending. With exports contracting and concerns resounding about the slowdown in China, the external environment has turned sour for the world's number 3 economy.

Long a pioneer in adopting unorthodox policies to tackle deflation and revive economic growth, the BOJ is now taking a page out of European policy makers' playbooks in the goal of stoking inflation. The yen tumbled after the announcement, especially that it came as a big shock to investors after Kuroda just last month rejected the idea of negative rates! "*This clearly shows the BOJ wanted to weaken the yen and raise the price of import goods and boost inflation*," said Daisuke Karakama, an economist at Mizuho Bank in Tokyo. "*We do not know this negative rate policy will be good for the economy in the end*," he said, adding that success in Europe does not guarantee the same for Japan.

The yen dropped markedly following the BOJ announcement, trading to a high of 121.87 against the dollar (last at 120.85). Japanese stocks zigzagged, rallying for 28 minutes, then falling sharply only to rise again as traders digested the news. The benchmark Nikkei index closed 2.80% higher on the day at 17,588 (still down 7.96% down year-to-date). Japanese bonds rallied sharply, with the benchmark 10-year yield dropping 13 bps to 0.09% (definitely a great long term investment! NOT)

Prior to that, and as highly anticipated, The Fed unanimously opted to keep its benchmark rate unchanged (0.25% -- 0.50%) at the January 27th FOMC meeting, after its decision to start raising rates in December 2015 followed a seven-year stimulus campaign because officials judged the economy was gaining strength. Officials last December said they expected to raise rates by about a percentage point in 2016 to gradually reduce those incentives

Still, the new policy statement suggested that the Fed's confidence in the economic outlook had since deteriorated. In December, it described the chances of faster and slower growth as "*balanced*." This time, the Fed reserved judgment: "*The committee is closely monitoring global economic and financial developments and is assessing their implications for the labor market and inflation, and for the balance of risks to the outlook*," the statement said. On one hand, the Fed noted that some economic measuring sticks were doing well, like continued job growth, more spending by businesses and consumers and the revival of the housing market. On the other hand, it said domestic economic growth apparently slowed in the final months of 2015.

Equity markets have fallen sharply in January, erasing wealth and weighing on confidence, while the dollar continues to gain strength, limiting demand for American exports. In response to the Fed announcement, equity markets fell broadly on Wednesday. The Standard & Poor's 500-stock index fell 1.1% to close at 1,882.95. The USD dollar weakened against its peers (last at 1.0920 versus the Euro and 1.4300 against the Sterling Pound) while the yield on the 10-year Treasury note closed unchanged at 2.0% (last at 1.93% on the back of weak US durable goods data yesterday and the BOJ surprise move this morning!).

The Fed aims to keep prices rising at about 2% a year, but it has consistently fallen short since the recession that lasted from the end of 2007 to the middle of 2009. The Fed's preferred inflation gauge, which excludes food and energy prices because they are volatile, rose 1.3% during the 12 months through November, the most recent available data. Public expectations about future inflation also are eroding, a problem because those expectations help to shape reality. The Fed reiterated Wednesday that it wanted to see "*actual and expected progress*" toward its 2% goal as it considers further interest rate increases. But the central bank also said it remained confident that inflation would begin to rise "*as the transitory effects of declines in energy and import prices dissipate and the labor market strengthens further*", and made clear that it still expected to raise interest rates "*gradually*".

Elsewhere, oil did rally in past days for a change (finally more buyers than sellers!) as Russia’s Energy Minister Alexander Novak confirmed in the past 48 hours that his country is willing to discuss the issue of cutting oil output volumes, but that has to be the consensus amongst all crude exporting nations. Novak confirmed that Russia would participate in talks with both OPEC and non-OPEC nations that Venezuela has proposed for February (however with no date and no confirmed meeting yet, one has to wonder how serious a Russia – OPEC (Saudi) compromise is!). March WTI traded yesterday to a high of US$ 34.82 on the back of strong rumors regarding an upcoming 5% cut in oil production, though was last quoted at US$ 33.25 (as the rumors got pushed back).

Disclaimer