Weekly Market Summary

4th of Dec 2015

The Perfect December Short Squeeze!! Fadi Nasser (SVP – Head of Treasury Sales)

In my previous weekly market coverage, I pointed out the fact that market participants were too complacent about the European Central bank (ECB) delivering on all monetary policy expansion promises and warned that risks to the consensus would see a sharp jump in European government bond yields and the value of the Euro against the US greenback. Namely, the following specifics were stated:

- ECB policy makers will meet in Frankfurt on December 3rd and economists' consensus is currently for a min. 15 bps cut to the deposit rate (last at -0.2%), along with an expansion of the quantitative easing program (with regards to size, composition and duration), with the latest Reuters median forecast going for an extension of the monthly ECB purchases by € 15 billion to € 75 billion.
- As weird as it sounds, an ECB rate cut seems very likely simply because the market is expecting it! (as recent European data had surprised to the upside).
- Whilst Draghi and Executive Board member Peter Praet - the institution's chief economist - have indicated more easing is in the cards, some governors have expressed unease. Estonia's Ardo Hansson, Slovenia's Bostjan Jazbec and Germany's Jens Weidmann have signaled since the last meeting that they see no need to ease policy further just now.
- **A less dovish ECB outcome at next Thursday's monetary policy meeting would surely result in a quick jump in European government bond yields and lead to immediate Euro strengthening.**

So what exactly happened yesterday, one might ask? Were Draghi's previous assurances that "*the ECB will do what is necessary to reach its inflation goal rapidly*" over amplified, and his aims were much more modest than the market thought? Or was the ECB President held back by other board members and simply decided not to push for extreme easing measures?

Whilst the overall picture remains unclear, my personal interpretation of yesterday's meeting/announcement is that "Super" Mario Draghi wanted to deliver a lot more, but was simply unable to push this through the Governing Council, with many members expressing concerns re more stimulus. Others, to the contrary, would argue that Draghi seemed pretty relaxed and comfortable in defending the new measures, and that the package was shaped by the various technical committees that were working out the options (in other words, the Executive Board might not have actually pushed for more). Additionally, if as stated by the ECB President during his press conference that a very large majority of governors were in favor of yesterday's package, it would not be clear what influence the few objectors would have had on the final decision (tell that to a stubborn German Bundesbank President!).

One thing is for sure: Relative to the tone of recent speeches by ECB President Draghi and its Chief Economist Praet - which had communicated growing concern about the low pace of euro-area inflation and the risks to the economic recovery, fuelling expectations of a substantial policy ease – yesterday's meeting delivered something much more modest. In fact, the package was even at the lower end of the range economists had considered reasonable in light of how the ECB was likely to view the macro outlook. Mario Draghi announced that Quantitative Easing ("QE") would be extended by six months until at least March 2017 at the current rate of € 60 billion euros a month, taking the total size to 1.5 trillion euros, and asset eligibility would be broadened to include local and regional debt. Additionally, the European central Bank reduced its deposit rate (the rate received by banks on their overnight deposits with the Eurosystem) by 10 bps to -0.30%. However, with markets priced for a 15-20 basis-point cut in the deposit rate, and most economists foreseeing a minimum increase of € 15 billion in the monthly pace of QE, disappointment swiftly kicked in, with the violent ensuing market reaction only confirming what Ben Bernanke (previous US Fed Chairman) had suggested in his recent book, namely that "*monetary policy is 98% communication and only 2% action*"!!

A quick look at the market's reaction clearly highlights traders' disappointment: European equities closed sharply lower with the Stoxx Europe 600 Index losing 3.1% and Germany's DAX Index falling 3.6%. European bonds tumbled, pushing Germany's 10-year yield up by the most since 2012 (yields soared a surreal 46% on the day, reaching 69 bps from 47 basis points earlier in the morning!). Last, the euro jumped over 3.5% against the dollar after the ECB press conference, trading at high of $1.0982 late yesterday's evening versus 1.0560 earlier in the day (last at 1.0893).

With the value of the U.S. fixed-income market sliding by US$ 162.5 billion yesterday, while the euro area's shrank by 98.3 billion euro (US$107.4 billion), it is very clear that the ECB comprehensively failed to live up to its own hype!! Going forward, surely both markets and forecasters will understandably take communications from Central Bankers with a correspondingly bigger pinch of salt! (The same must apply to GIB's valuable clients, with many still taking US Federal Reserve's assurances - re a future gradual rise in US rates - for granted).

This afternoon, market focus will shift to the US November job release (4:30 pm Bahrain time), following Fed Chair Janet Yellen's remarks earlier this week that an interest rate increase is in play for their December meeting (December 16th) and economists' current anticipation that rate normalization will begin less than two weeks from now. So maybe - just maybe - for once the upcoming jobs report may not be the most critical of all time, though this payrolls data is surely expected to offer more information about the pace of tightening in the months ahead. Economists will be closely watching the following details: Bloomberg's consensus is for a 200,000 increase in jobs for the month of November, an unchanged unemployment rate (at 5.0%) & average workweek (at 34.5 hours), and a small pickup in wages (+0.2% MoM/ +2.3% YoY).

Also of great interest - later in the day - will be the outcome of OPEC's meeting, with many analysts looking for the current status quo to be maintained after member states gave the strongest signal yet they would not agree to curb output at the group's meeting in Vienna later this evening. *"I don't expect OPEC to do anything,"* Iran's Oil Minister Bijan Namdar Zanganeh said on Friday morning as the group's ministers sat down to discuss policy, including how to fit new member Indonesia into its output ceiling.

The market is oversupplied by 1.5 million to 2 million barrels a day, he said. Iran, which plans to pump an additional 500,000 barrels a day once international sanctions over its nuclear program are lifted, said it is only willing to discuss output cuts when its production reaches 4 million barrels a day. Saudi Arabia also reiterated its position that other big producers outside the group such as Russia would have to join any output cuts by the Organization of Petroleum Exporting Countries. With oil prices hovering near a six-year low, cash-strapped countries including Venezuela, Ecuador and Algeria are pressuring Saudi Arabia to cut production. "*Saudi Arabia is willing to cooperate with anyone to re-balance the market*", Saudi Oil Minister Ali al-Naimi told reporters earlier today. The pressure is not solely on Saudi for output cuts, he added, pointing that Iran's return will do nothing to the market as demand for oil will strengthen next year. Russia, Mexico and other big producers outside OPEC have given no indication they would agree to any OPEC-led output cuts. Russian Energy Minister Alexander Novak said Thursday that the country doesn't see a production cut as viable.

Follow-Up Commentary (late in the afternoon)

OPEC DECISION

OPEC agreed to set a new oil-output ceiling of 31.5 million barrels a day, a level that is more in line with the group's most recent production estimate. Crude fell as much as 3.6% on the news in the past hour and was last trading at $40.00 a barrel for US WTI.

The increase is from a previous output target of 30 million barrels and does not include production from Indonesia, which joined the producer group after a break of almost seven years. OPEC pumped about 31.4 million barrels a day of crude in October, according to estimates in its monthly market report.

Venezuela, whose foreign currency reserves are at the lowest level in 12 years, led calls for a reduction in output, supported by Ecuador, while Iran is poised to boost output after sanctions over its nuclear program are lifted and it won't seek permission from OPEC to do so, Zanganeh said last month. OPEC requires consensus among members to alter its output ceiling. Global oil stockpiles have risen to record levels as Saudi Arabia, Russia and Iraq boosted supply, the IEA said on Nov. 13. The market is oversupplied by as much as 2 million barrels a day, Zanganeh said this week, equivalent to about 2% of global output.

US NONFARM PAYROLL

Comments from Janet Yellen earlier this week suggested she did not need to see much from today's figures to initiate a first rate hike this month, and the data easily surpassed what was required: The 211,000 increase in November payrolls, while not at the heights of October, was slightly ahead of expectations and accompanied by a net 35,000 upward revision to the prior two months. Even though average earnings decelerated to a 2.3% year-over-year rate, that was in line with the consensus expectation and the series is still suggesting that wage growth is breaking out of its previous range of close to 2%. The wider measure of unemployment (the "U6" that includes part-timers who want a full time job) rose to 9.9%, from 9.8%, but that was partly due to an increase in labor force participation (last at 62.5% from 62.4% the previous month). Overall, not great, but surely good enough for the Fed to start raising interest rates later this month (December 16th FOMC meeting).

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