Weekly Market Summary

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Market Complacency At Its Best ! Perfect Time for President Trump to Fire More Opponents!!
Fadi Nasser - Head of Treasury Sales

With the French election ending in a victory for Emmanuel Macron, one more event that was thought to threaten global stability did make a quiet exit! For investors already looking at record-low price turbulence, the defeat of far-right candidate Marine Le Pen at the polls last Sunday meant investors could breathe a sigh of relief, focus again on a strong earning season and signs of global economic growth, whilst taking more risk from the table. As a result, European stock volatility measured by the Euro Stoxx 50 Volatility Index fell to the lowest since March on Monday, while the CBOE Volatility Index ("VIX") decreased 7.6% to 9.77, the lowest since 1993 (it closed yesterday slightly higher at 10.72). At the same time, a measure of volatility in the US$14 trillion Treasuries, the Merrill Lynch Option Volatility Estimate or MOVE Index (derived from over-the-counter options on Treasuries maturing in 2 to 30-years), dropped yesterday to 54.4670 - the lowest level since August 2014.

"*Complacency has returned in such quick fashion that it is starting to feel like 2005-06, when nothing seemed to upset the broader markets*," George Goncalves, a fixed income strategist at Nomura, wrote in a recent note to clients. Even US President Trump's abrupt firing of FBI Director James Comey (and the man overseeing the agency's probe into contacts between the Trump presidential campaign and Russian officials) earlier this week, persisting threats from North Korea, a crackdown on debt in China as well as heightened confusion over the future of US trade agreements, tax reforms and financial regulation plans have all done little to shake markets - a sign that both equity and bond traders are feeling quite comfortable trading current narrow market ranges. The explanation may lie in economic data, both in the U.S. and abroad, that has either kept up with analyst expectations or exceeded them. At the same time, the US Federal Reserve has brushed aside signs of weakness in the world's largest economy during the first quarter of 2017 (preliminary reading of +0.7% annualized growth), leaving benchmark rates unchanged at their March 15th meeting, though signalling they are still on track to hike two more times this year (an expectation shared by market participants betting on the path for rates). "*Traders have learned to look beyond pessimistic forecasts on major market events that ended up fizzing out*", Ethan Harris, global economist at Bank of America Merrill Lynch in New York, said in an interview last March. Furthermore, central banks have shown they will step in to support markets and economies, providing a safety net. "*It has been a period of repeated shocks and I think people get toughened against that," Harris added. "It seems like uncertainty is the norm, so you just learn to live with it*."

Nonetheless, just when investors think they have it all figured out, the market can <u>and</u> typically does bite! So goes the reasoning of Goldman Sachs chief Lloyd Blankfein, who has warned that such low volatility is not the "*normal resting state*" for markets. "*Every time I get accustomed to low volatility, like we were towards the end of the Greenspan era, and we think we have all the levers under control and there is low risk in the world, and the market is awash with liquidity that pounces on every aberration in the market, something erupts to remind us that the idea anybody is in control of anything is hubris*," Blankfein said in a May 9th interview with CNBC (*I couldn't have said it better myself! Well stated LLoyd!)*

Below are other main stories - we have been monitoring at our end over the past few days - that could soon affect markets & volatility in a big way - one way or another:

- **Shrinking the Fed's Balance Sheet**: The US Federal Reserve's plans to unwind the multi-trillion stimulus programme put in place after the 2008 financial crisis and shrink its $ 4.5 trillion balance sheet later this year will likely mean a scarcity of US Dollars outside the US and lead to possible turmoil in illiquid emerging markets When two big international organisations - namely the International Monetary Fund (IMF) and the Bank for International Settlements (BIS) highlight the same issue - investors should take note and pay closer attention! After all, it was this deluge of cash that lifted asset prices and pushed down borrowing costs globally in recent years. It has also helped spur growth of new markets, such as an international dollar-denominated bond market in Asia, where borrowing has reached record levels this year. Once the Fed slows its purchases of Treasuries and other securities, the dollars effectively pumped out around the world through those deals will start to disappear. US dollars could also be drawn back to the US under any tax amnesty granted by Washington that allows companies to repatriate hundreds of billions – or trillions according to Treasury secretary Steven Mnuchin - in profits held overseas to avoid paying US-level taxes. Studies suggest the majority of those funds are already held in the US currency. Asia generally is likely to be hit hard by any withdrawal of dollars. Every US$ 100 increase in the Fed's QE programme sent US$ 15 to Asia for a cumulative inflow of US$ 500 billion, according to Sameer Goel, head of Asia macro strategy for Deutsche Bank.

- **ECB's QE Tapering Agenda:** Mario Draghi faced a rare public grilling on Wednesday that left the president of the European Central Bank nervous as he defended some of his unpopular policies to Dutch MPs. The usually calm central banker was provoked by hostile questions about the euro and the ECB's measures to revive the Eurozone economy. Confronted with the possibility of the Netherlands quitting Europe's monetary union by Eurosceptic MP Thierry Baudet, an angry Mr. Draghi said: "*The euro is irrevocable. This is the treaty. I will not speculate on something that has no basis*." Highlighting the ECB's role in the Eurozone's economic recovery, he said policies had helped generate growth and create 4.5 million jobs. "*That is the reality, the rest is speculation*." The Dutch political establishment has been fiercely critical of the ECB's stimulus measures, which have seen the central bank buy more than €1.8 trillion of assets over the past two years and cut interest rates to record lows. Mr. Draghi faced accusations that he had raided Dutch pensioners' wealth through ECB policies: Many Dutch share the German view of blaming the central bank's measures for eroding their savings. MPs finished the session with a gift of a solar-powered tulip for Mr. Draghi, to remind him of the country's famous Tulip Mania asset price bubble and financial crisis in the mid-17th century. "*We want you to look at this tulip before your meetings,*" said Pieter Duisenberg, the head of the finance committee and son of Wim Duisenberg, the ECB's first president. Although the European Central Bank left policy settings unchanged at its April 27th meeting, a debate relating to QE tapering has already begun, with various members of the Bank's governing council expressing divergent views about when and how to end monetary stimulus. On the question of when, the improvement in economic activity and uptick in headline inflation is prompting calls to pull the plug on monetary stimulus sooner. But core inflation, which excludes volatile energy and food prices, remains stuck at about 1%. And although Germany and Ireland may be ready for exit, Italy and Portugal — with lower core inflation, higher output gaps, and more non-performing loans - are not. On the question of how, the ECB's default exit strategy - like that of the US Federal Reserve - seems to be to undo monetary stimulus in reverse: First taper quantitative easing, then normalise interest rates; and finally shrink the ECB balance sheet. The ECB June 8th monetary policy meeting is highly expected to be a market mover! Stay tuned!

- **Oil Prices Gyrations:** Oil prices bottomed last Friday and started this week on a positive note. They extended their gains on Wednesday after a report showed US crude stockpiles fell by the biggest margin since December and were down for the fifth straight week.

Inventories of US crude fell by 5.25 million barrels in the week ended May 5th, according to the Energy Information Administration (*My reference last week to the Department of Energy's Disinformation*). This was the largest streak of back-to-back declines in US oil stocks since September. The larger-than-expected drop came alongside weaker imports, which averaged over 7.6 million barrels per day last week, down by 644,000 barrels per day from the previous week. At 522.5 million barrels, US crude oil inventories remain still at near record levels. June West Texas Intermediate future, the US crude marker, is last trading at $47.85 barrel (low of $ 43.76 last Friday), while Brent crude, the global oil benchmark, sits at $ 50.75 a barrel. Despite solid expectations that OPEC and Russia will extend their oil output cuts (at their May 25th OPEC meeting in Vienna) into the second half of the year and possibly beyond - amid news that Saudi Arabia is prepared
to do "whatever it takes" to end supply glut - crude continues to trade on the soft side as markets grow anxious about a slowing Chinese economy amid concerns that US production (currently approaching the 9.5 million barrels a day) and the oil cartel's exports are undercutting production curbs. "*OPEC is now recognizing they need longer -- and potentially deeper -- production cuts than they have anticipated*," said Jamie Webster, a senior director for oil at the Boston Consulting Group Inc. in New York. U.S. shale producers used the price spike that OPEC triggered earlier this year to lock-in revenues for 2017, 2018 and, in some cases, even 2019. With their financial future relatively secure, they can now deploy more rigs (since the count of active rigs in the U.S. reached a low last June 2016, producers have added an average seven units per week, the strongest recovery in 30 years).

- **South Korea Election:** The victory of Moon Jae-In in South Korea's presidential election was widely expected, but is no less welcome! Moon now has a chance to stop the political corrosion in a country whose democratic development has not always kept pace with its remarkable economic growth. Ms. Park was impeached in the national legislature and the decision upheld by Korea's constitutional court. The subsequent electoral victory for Mr. Moon, a former human rights lawyer from the opposition Democratic party, promises a possibility for change that goes beyond simply electing another politician to continue the existing patterns of governance. Mr. Moon has the chance to clean up Korea's cloudy political culture, strengthen the norms of corporate governance, boost the productive potential of an underperforming economy, and even establish a position in foreign policy that gives Seoul its proper role in confronting the problems of North Korea. It is in the last of these issues, perhaps, where the greatest uncertainties and biggest risks lie: South Korea is caught between the two foreign policy hegemons of Asia - the US, whose influence has been waning but which nonetheless retains a strategic role, and China, which has become increasingly assertive in the region.

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