Weekly Market Summary

20th of March 2017

Robert Shiller & Neel Kashkari Feel Nervous About the Trump Rally & US Economy !! Should We Be Worried Too ?? My Guess is Not Yet ………… Fadi Nasser - Head of Treasury Sales

Robert J. Shiller - born March 29th, 1946 - is an American Nobel Laureate, economist, academic, and best-selling author. He currently serves as a Sterling Professor of Economics at Yale University and is a fellow at the Yale School of Management's International Center for Finance. The last time Professor Shiller heard equity investors talk like this in 2000, it did not end well for the bulls. Back then, the Nobel Prize-winning economist says traders were captivated by a "*new era story*" of technological transformation: The Internet had re-defined American business and made traditional gauges of equity-market value obsolete. Today, the game changer everyone's buzzing about is political: President Trump and his bold plans to slash regulations, cut taxes and turbo-charge economic growth with a trillion-dollar infrastructure boom!

"*They are both revolutionary eras*," says Robert Shiller, who is famous for his warnings about the dot-com mania and housing-market excesses that led to the global financial crisis back in 2008. "*This time a 'Great Leader' has appeared. The idea is, everything is different*." For Shiller, the power of a new-era narrative helps answer one of the most hotly debated questions on Wall Street as stocks set one high after another this year: Why are traders so fixated on the upsides of a Trump presidency when the downside risks seem just as big? "*For all his pro-business promises, the former reality TV star's confrontational foreign policy and haphazard management style have bred uncertainty -- the one thing investors are supposed to hate most!*" Still, Shiller adds that when markets are as buoyant as they are now, resisting the urge to pile is hard regardless of what else might be happening in society (the usual "herd mentality" thinking!). On whether stocks are nearing a top, Shiller cannot say with any certainty, especially that he is reluctant to make short-term forecasts.

Neel T. Kashkari - born July 30th, 1973 - is an American banker and politician who took office January 1st 2016 as the 13th President of the Federal Reserve Bank of Minneapolis. Mr. Kashkari has a bachelor's and a master's degrees in mechanical engineering, both from the University of Illinois, and an MBA from the Wharton School at the University of Pennsylvania. Prior to his latest assignment, Neel was managing director and member of the executive office at PIMCO, while he served before that at the US Department of the Treasury from 2006 to 2009, first as senior adviser to Secretary Henry Paulson (both ex-Goldman Sachs senior employees) and then as assistant secretary of the Treasury. In the latter role, he established and led the Office of Financial Stability and oversaw the Troubled Assets Relief Program ("TARP") for both Presidents George W. Bush and Barack Obama.

At last Wednesday's March 15th FOMC meeting, where the Fed – as widely expected - raised the overnight Fed funds target by 25 bps to a range of 0.75% - 1.00%, there was only one surprising dissent, and it came from no one other than Mr. Kashkari. The former aerospace engineer has recently stated that inflation is not a major concern, and therefore believes rates should be kept low to further boost growth and ensure it is more widespread "*across all our people and businesses*". Other Fed officials disagree: "*In view of realized and expected labor market conditions and inflation, the Committee decided to raise the target range for the federal funds rate. The Committee expects that economic condition will evolve in a manner that will warrant gradual increases in the federal funds rates*". Fed Chair Janet Yellen further explained the Fed decision in her ensuing press conference, stating that "*our decision to make another gradual reduction in the amount of policy accommodation reflects the economy's continued progress. Today's decision is in line with that view, and does not represent a reassessment*."

And yet, financial markets are telling Yellen there is more work to be done - or else! Whilst US short term rates were raised by 25 bps, the outlook was less hawkish than market participants foresaw, with projections for the medium-term tightening cycle largely unchanged from December 2016 projections, despite rising inflation expectations and easing financial conditions (Fed still anticipates 2 more 25 bps rate hikes for 2017 and 3 rate increases for 2018 and 2019). That in turn propelled markets -- judging by the strength of the U.S. dollar, bond yields, credit spreads, and stock prices -- to effectively deliver a rate cut to the tune of about 15 basis points, according to indexes published by Morgan Stanley and Goldman Sachs Group Inc. "*Our financial conditions index eased by an estimated 14 basis points on the day -- about 2.3 standard deviations and the equivalent of almost one full cut in the funds rate -- and is now considerably easier than in early December, despite two funds rate hikes in the meantime*,'' Goldman Chief Economist Jan Hatzius and team wrote in a note. All of this leaves Yellen facing a predicament similar to one that former Fed Chairman Alan Greenspan called a conundrum in February 2005, when the central bank was raising borrowing costs and long-term yields kept falling and equity markets rallied. At the time, the dilemma was blamed on a global glut of savings. This time around, U.S. financial conditions have loosened decisively since the Fed raised short-term rates last December, its first hike since the same month in 2015, in turn delivering stimulus to the U.S. economy, while vexing the central bank's tightening cycle.

The simplest explanation for this bullish market reaction may be that share prices have less to do with Trump and Fed decisions, given the tangible improvements in the economy and corporate earnings. With the U.S. unemployment rate well below 5% (last 4.7%) and S&P 500 Index profits projected to reach all-time highs this year, perhaps it should not be surprising that equity and credit markets are doing so well! But there is more to the market's resilience than just numbers, according to Ethan Harris, Bank of America Merrill Lynch's global economist in New York. Like the fable of the boy who cried wolf, Harris says pessimistic forecasters have so badly over-estimated the consequences of big events -- the rolling European debt crisis since 2010, the U.S. debt-ceiling standoff in 2011, Brexit in 2016 -- that traders have become conditioned to ignore them. Even when bears are right, the past eight years have shown that central banks are more than willing to save the day when markets fall. "*It has been a period of repeated shocks, and I think people get toughened against that*," Harris says. "*It seems like uncertainty is the new norm, so you just learn to live with it*."

Last, but not least, a quick summary of other important economic/political headlines worth following:

- **Dutch Elections**: Dutch voters turned out in force to back pro-European parties and help Prime Minister Mark Rutte's Liberals easily beat off an election challenge by the anti-Islam Freedom Party of Geert Wilders, drawing a line in the sand over the spread of populism. With 95% of votes counted, the Liberal Party was forecast to take 33 seats in the 150-seat lower house of parliament to 20 seats for the Freedom Party. The Christian Democrats and the centrist D66 party were both one seat behind Wilders. Informal talks on forming a coalition will soon start and may take months, as is commonplace in the Netherlands. The outcome suggests that the nationalist sentiment that prompted the U.K.'s Brexit vote and won Donald Trump the White House will struggle to secure as big a foothold in Europe's core. The euro climbed to the highest level in more than a month on the result, which was hailed by leaders across Europe. With key elections in France in April and May, then in Germany in September, Wednesday's vote in one of the EU's founding members was in the international spotlight like never before.

- **European Central Bank Discussions**: European Central Bank policy makers considered the question of whether interest rates could rise before their bond-buying program comes to an end, according to people familiar with the matter. Governing Council members meeting on March 9th exchanged views on ways of communicating and sequencing an exit from unconventional stimulus, euro-area central-bank officials said, asking not to be identified because the deliberations were private. After years of extraordinary stimulus to combat economic distress and the threat of deflation, a steadily improving recovery is finally giving monetary officials room to consider normalizing policy. If raising rates before the end of QE were to be considered a realistic path, that would mark a departure from the guidance on timing of rate hikes that ECB President Mario Draghi has given since March 2016, when he lowered the deposit rate to minus 0.4%. "*The Governing Council expects the key ECB interest rates to remain at present or lower levels for an extended period of time, and well past the horizon of our net asset purchases*." Yesterday's hints by ECB Governor Nowotny with regards to upcoming rate hikes in Europe propelled the EUR to its highest level in five weeks against the USD (high 1.0784, last 1.0770).

- **US Debt Ceiling**: Market focus – this week - shifted to the March 15th US debt ceiling suspension deadline that former US President Obama and House of Representatives Speaker John Boehner put together right before the last election in October 2015. With that date expiring, the debt ceiling will freeze in at $ 20 trillion. The US Treasury has currently roughly US$ 200 billion in cash, and burning it at a rate of US$ 75 billion a month, one would expect the $ 20 trillion mark to be reached in early summer, and the US Treasury to be left out of cash, leading to a government shutdown and one giant fiscal bloodbath where everything could "*grind to a halt*" (forget then about tax cut or infrastructure stimulus!). Such disastrous outcome could be delayed for few months should emergency measures be introduced in coming weeks, though will need to be addressed at the earliest. Many market analysts had previously assumed that the usual rancor over raising the debt ceiling would be a thing of the past now that Republicans control the executive and legislative branches of government. However, the big uncertainty lies in the fact the Republican Party is not a monolithic entity when it comes to policy positions on fiscal discipline, with some of its elected representatives consistently voting against raising the debt ceiling to reflect the conservative aspirations of their constituencies. That only means navigating the debt ceiling may be the first real challenge of the Republican-led Congress.

- **UK Monetary Policy Committee (MPC) meeting**: One vote does not make a Bank of England interest-rate increase more likely! Kristin Forbes's lone call for a hike at this week MPC meeting may have been augmented by minutes that indicated some other policy makers may not be far behind her, but history shows it is a long path from a single vote to a majority. The bank kept the benchmark rate at 0.25% on Thursday in an 8-1 vote that saw Forbes unexpectedly support an increase to 0.5%. Some of those in the majority said it might not take much more strength in either inflation or growth for them to also shift to the view that the economy needs some air taken out of it. Financial markets are more skeptical. While sterling swaps data shows bets on a hike by mid-2018 increased after the decision, the probability of one this year remains below 30%. The chance by the end of 2018 is at 65%.

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