Weekly Market Summary

21st of April 2017

Double Jeopardy: Should Investors Get Worried Again, Now That The US Fleet Sets Sail - For Real This Time - for North Korea ?!?

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Donald Trump will never cease to amaze me! When the U.S. President boasted early last week that he had sent an "armada" as a warning to North Korea, the aircraft carrier strike group he spoke of was still far from the Korean peninsula, and headed in the opposite direction. Despite representations by Trump and defence advisers, the U.S. Carl Vinson carrier was thousands of miles away on exercises off northwest coast of Australia. And when North Korea displayed over the weekend what appeared to be new missiles at a parade and later staged a failed missile test, the strike group was even farther away, moving through the Sunda Strait and then into the Indian Ocean! Nonetheless, there is no need to worry as we are assured that the Vinson is now proceeding to the Western Pacific as ordered. The perceived communications mix-up has raised eyebrows among military experts, who wonder whether it erodes the Trump administration's credibility at a time when U.S. rhetoric about the North's advancing nuclear and missile capabilities are raising concerns about a potential conflict. "*If you threaten them and your threat is not credible, it is only going to undermine whatever your policy toward them is! And that could be a logical conclusion from what has just happened*," said North Korea expert Joel Wit at the 38 North monitoring group, run by Johns Hopkins University's School of Advanced International Studies.

Moving to more credible news stories, US Treasuries – the world’s biggest and most liquid bonds – did finally break out of their tight 2017 trading range, though at this stage it remains unclear whether the latest move (sharp drop in yields – down from 2.63% to 2.16% on 10s UST, last at 2.24%) will be sustained over the near future. Investors are questioning the strength of the U.S. economy and the Fed’s plan to raise rates three times in 2017 after a weaker-than-expected March jobs gain, and a surprise monthly drop in consumer prices and retail sales data. They are also voicing disappointment that President Donald Trump’s proposed tax cuts and infrastructure spending plans have yet to materialize.

However, despite first-quarter annual growth forecasts – 2016 Q1 GDP number to be released on April 28th – dropping towards 1% (first quarter growth weakness seems to be an annual event!), the second-quarter consensus forecast still sits at a very robust 3.0%. So, with future growth coming in above potential and inflation at or near the Fed’s targets, much of the causation of this latest move in bonds falls into two categories: Washington gridlock and geopolitical fears. Increasingly, traders are left reacting to geopolitical risks from North Korea to Russia and Syria. They also heard President Trump talking the US dollar lower and declaring his preference for low US interest rates, now that he is in the Oval Office (previously presidential candidate Donald trump accused the Fed and Chair Janet Yellen of playing politics with low interest rates, criticizing powerful “global special interests” that drive economic decisions! But who can blame him for flip-flopping?!). Those factors seem unlikely to disappear in the weeks ahead.

The final piece of the geopolitical risk puzzle is the French election. France will be heading to the polls on Sunday for the first round of one of the most tightly fought battles for the Elysee Palace in decades. Four leading contenders with radically different views on the economy and Europe are all within touching distance of qualifying for the run-off, making it the most uncertain presidential election for 50 years - and one with potentially huge ramifications for France and the EU. The betting odds remain biased toward a win by centrist Emmanuel Macron (market friendly outcome). And whilst the surprise pro-Brexit vote in June that led traders/hedge funds to happily grab 10-year Treasury notes paying yields of just 1.375% could be a useful road map in case of a shock victory by nationalist Marine Le Pen, peaceful transition in a Western democratic society cannot be compared to U.S./Russian conflict in Syria or war in Korea in terms of risk-off shock value.

As US bond and equity markets establish new trading ranges, it seems that the "Trump trade" positions have been mostly washed out. At some point, the market will revert to a traditional focus on the solid U.S. fundamentals and Fed rate hikes. And unless investors start believing the Federal Reserve will ease monetary policy (which I surely don't!), it is getting harder to reconcile what are still historically depressed bond yields and relatively high stock prices. More consistent and sustainable levels probably lie somewhere in the middle, with government bond yields moving up and stock prices down. Exactly where, as well as when and how we would get there will depend primarily on the balance between geopolitical and economic-policy influences.

Last, but not least, a quick word on the latest IMF global growth assessment and UK Prime Minster May's surprising announcement in past days:

- The latest IMF's "World Economic Outlook": The baseline for economic growth is essentially the same over the medium term, with slightly better shorter-term prospects; the risks are getting bigger and are tilted to the downside. Only better national policy making and improved cross-border coordination can lift prospects. The IMF now forecasts annual average growth for the global economy of about 3.5% in 2017-18 (it raised its 2017 global growth outlook by 0.1% on improved conditions in Japan, UK and China), similar to the levels for 2012-2015. That will rise to 3.8% in 2022. In terms of components, after reaching 2% in 2017, the advanced economies are projected to grow at just 1.7% in 2022 as three drivers (the euro zone, Japan and the U.S.) lose some steam. In contrast, the annual growth rate in emerging and developing countries is projected to rise to 5%.

- UK Prime Minister Theresa May won by a landslide the approval she wanted for a June 8th snap election as she seeks to strengthen her mandate ahead of Brexit negotiations. Lawmakers in the House of Commons voted 522 to 13 on Wednesday in favour of her plan to hold an election three years earlier than scheduled (previously in year 2020). The result paves the way for an intense seven-week campaign in which the U.K.'s tense relationship with the European Union will undergo scrutiny less than a year since the country voted in a referendum to leave the bloc. With polls showing May's Conservatives with a commanding lead over her main rival (21% lead), the prime minister is calculating she can increase her slim majority of just 17 lawmakers and negotiate the kind of Brexit she wants without being swayed by hard-liners in her party. If she can extend her parliamentary majority, May will also be able to silence critics who have opposed her own policies, not just on Brexit but also tax and education. What is more, it means she would no longer be Prime Minister by default after replacing David Cameron last July. GBP/USD jumped on Wednesday to a five-month high, breaking out of the $ 1.20-1.27 range it had been anchored to since Mid-October, and trading to a high of $ 1.2910 (last seen at $ 1.2800). With the opposition weakened, and given the UK's comparative growth, inflation and interest rate situation, some analysts believe sterling remains cheap around current levels and could soon be headed to $ 1.35. But for other investors, a snap election merely adds an unwanted major political event to an already crowded agenda!

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