Weekly Market Summary

24th of February 2017

Will Recent Developments in Sweden Have Any Lasting Impact on the Fed's Rate Decision in March?! Depends on Who You Ask!

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Swedes have been scratching their heads and making jokes about US President Donald Trump's remarks that suggested a major incident had occurred in the Scandinavian country. During a rally in Florida last Saturday, Trump told his followers to look at what had happened in Germany, Paris, Brussels and Nice, in apparent reference to the terror attacks there. He then added “*Look what's happening last night in Sweden. Sweden..who could believe this.. Sweden*". It was not clear what the US president was referring to as there were no high-profile situations reported the previous night (similarly, in past weeks Trump’s counsellor Kellyane Conway referred to a Bowling Green Massacre that never occurred, triggering a public feud with “Fake News” CNN!). Sweden’s Foreign Ministry spokeswoman Catarina Axelsson said that the government was not aware of any "*terror-linked major incidents,*" whilst the Security Police said it had no reason to change the terror threat level. Former Swedish Foreign Minister Carl Bildt tweeted, "*Sweden? Terror attack? What has he been smoking? Questions abound,* "and another Twitter user said "*After the terrible events of last night in Sweden, IKEA have sold out of this*" and posted a mock Ikea instruction manual on how to build a "*Border Wall*," saying the pieces had sold out! ☺

Moving to serious matters, French political soothsayers remain convinced that National Front leader Marine Le Pen will not succeed in her bid to become French president in the country’s two-stage election (1st round scheduled for April 23rd, run-off election planned for May 7th, 2017). However, traders and investors seem less relaxed about the outcome. After the shocks of the U.K. voting for Brexit and Donald Trump becoming U.S. president in 2016, they are right to be taking out extra insurance. According to figures compiled by the website Oddscheker.com, the three main candidates are now neck-and-neck to become the next French president, based on the odds available from bookmakers. Republican candidate Francois Fillon has recovered ground lost during revelations he paid his family as staff members, while independent candidate Emmanuel Macron boosted his run for the presidency on Wednesday afternoon, after agreeing to an alliance with his centrist rival Francois Bayrou (to avoid splitting the moderate vote). The only constant in the race remains Marine Le Pen, with recent polls showing her winning the first round with a steady 26-28% of total cast votes.

As a result, French borrowing costs have been heading higher, with the 10-year yield surpassing 1% for the first time in a year. But it is the yield spread to Germany, the euro region’s benchmark borrower, that is showing the most stress, reaching its widest since July 2012 (spread between 10-year German Bund and French Oat yields last at 74.5 bps). In addition, yields on short-term German bonds have hit record lows this morning (**-0.97%** on 2-year notes! “Silly” and “Surreal” are the two words that come straight to mind, especially given the marked improvement in German economic data lately!). Bond buying by the European Central Bank had already pushed short-term German yields deeper into negative territory (*the ECB in December expanded the universe of debt it can buy to include bonds yielding below the deposit rate, which is currently minus 0.4%)*, but investors also pointed to a growing market sensitivity to French and Greek political developments/uncertainties (*possibly the same “herd mentality” investors that will be happy to sell these bonds at much lower prices / higher yields in coming weeks*).

Last, but not least, Federal Reserve officials have expressed confidence they can raise interest rates gradually, while a hike “*fairly soon*” might be appropriate to avoid the risk of an overheated economy, according to minutes of the Federal Open Market Committee’s (FOMC) latest meeting, released on Wednesday in Washington. “*Many participants expressed the view that it might be appropriate to raise the federal funds rate again fairly soon if incoming information on the labor market and inflation was in line with or stronger than their current expectations or if the risks of overshooting the Committee’s maximum-employment and inflation objectives increased*,” the minutes noted. Records of the January 31st / February 1st gathering (2-days meeting) also showed Fed officials wrestling with uncertainty on issues ranging from the Trump administration’s fiscal stimulus plans to the headwinds a rising dollar may pose. The discussion of a rate hike “*fairly soon*” was tempered by other comments that indicated little concern about near-term inflation risks. A few participants “*noted that continuing to remove policy accommodation in a timely manner, potentially at an upcoming meeting, would allow the committee greater flexibility in responding to subsequent changes in economic conditions*.”

As a reminder, U.S. central bankers left the target range for their benchmark lending rate unchanged at 0.5% to 0.75% at the conclusion of their last meeting. Fed Chair Janet Yellen told Congress in her semi-annual testimony last week that “*a further adjustment of the federal funds rate would likely be appropriate*” if the economy continues to evolve in line with their expectations. Traders are still pricing in about a one-in-three chance (34%) of a rate increase when the FOMC next meets on March 15th. Such low assigned probability by market players for an imminent rate hike has led Mohamed El-Erian - Allianz SE’s chief economic adviser – to warn traders not to get complacent about the prospect of a Federal Reserve interest-rate hike next month. Given the minutes from the Fed’s February 1st meeting and recent economic data, the market’s implied probability of an increase in March "*seems too low*," El-Erian recently tweeted. He added that a probability of 50% to 60% appears more appropriate! For El-Erian, the February jobs report, to be released March 10, will be significant. The jobs report, especially wage growth, will have a "*notable impact*" on the Fed’s thinking at the March meeting, "*one way or the other*," El-Erian added in a second tweet (*guess will have to agree with Mr. El-Erian on this call*, *even though Fed officials are well known to err on the side of caution ahead of major political/geopolitical events).*

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