Weekly Market Summary

Sep 15th, 2017

Should Investors Be Concerned About North Korea's Latest Threat to "Sink" Japan?! Depends Whether You Ask a Bond or Equity Investor !!

Fadi Nasser - Head of Treasury Sales

Yesterday, North Korea threatened to destroy Japan with nuclear weapons and "*reduce the US mainland to ashes and darkness*" in response to the countries' effort to ramp up sanctions on the isolated east Asian nation. "*The four islands of the [Japanese] archipelago should be sunken into the sea by the nuclear bomb of Juche*," the country's Asia-Pacific Peace Committee said in a statement carried by state news agency KCNA. "*Japan is no longer needed to exist near us.*" Juche, or "*self-reliance*", is the official ideology of North Korea, originally crafted in the 1950s by founding father Kim Il Sung - grandfather of the current supreme leader, Kim Jong Un. Accusing Japan of "*dancing to the tune of the US sanctions*", the peace committee also said Tokyo had "*not yet come to its senses after the launch of our ICBM over the Japanese archipelago*", in reference to North Korea's ballistic missile fired late last month over Japan's northern island of Hokkaido, a move that prompted US president Donald Trump to warn that "*all options are on the table*" for dealing with Pyongyang's weapons programmes. Yoshihide Suga, Japan's cabinet secretary, hit back at North Korea late Thursday, saying the threat to his nation was "*outrageous and provocative in the extreme*" and warning that it would "*considerably raise regional tensions*".

Overnight, North Korea followed on its threats - firing another ballistic missile over Japan, a direct challenge to the United States and China just days after a new sanctions resolution adopted by the United Nations Security Council that was intended to force the country to halt its accelerating nuclear and missile tests. The missile was not aimed at the Pacific island of Guam, which President Trump had warned could prompt a military response after North Korea threatened to fire missiles into the sea near the island last month. Instead, it blasted off from near the Sunan International Airport north of Pyongyang, the North Korean capital, and flew about 2,300 miles directly east, flying over northern Japan and falling into the Pacific Ocean. That is a slightly greater distance than between the North Korean capital and the American air base in Guam, and American officials, scrambling to assess both the symbolism and importance of the test, said it was clearly intended to make the point that the North could reach the base with ease. Neither the United States nor Japan tried to shoot down the missile, perhaps because it was clear moments after the launching that it was not aimed at land. "*The North American Aerospace Defense Command determined this ballistic missile did not pose a threat to North America*," Cmdr. Dave Benham, a spokesman for United States Pacific Command, said in a statement. It also concluded that the missile "*did not pose a threat to Guam*."

Intelligence officials have said in recent days that they believe that if Mr. Kim is willing to enter talks over a freeze of his nuclear and missile testing - and they are uncertain that he is - he will only do so after he has established that he can launch a nuclear weapon capable of hitting American territory. Today's missile flight, with a long arc that peaked at an altitude a little less than 500 miles, took him close to demonstrating that he can accomplish just that. It was the 15th missile test by North Korea this year and the first since North Korea detonated its most powerful nuclear bomb to date on September 3rd. Still, market reaction - so far - has surprisingly been muted, with traders shrugging off news that the latest rocket launch by Pyongyang had once again overflown Japan – though remaining cautious ahead of any potential reaction from the US. The Japanese yen was the biggest mover in major currencies, losing 0.6% against the dollar to trade at ¥111.20, having briefly strengthened as much as 0.6% to ¥109.56 immediately following the launch (surely if Japan will soon be sunk, traders' "mind-controlled" first reaction would be to buy the Japanese yen ☺) .

The broader market response was also relatively minor compared with those that followed earlier rounds of weapons testing by North Korea. Asian and US futures (last at 2.20%), after dipping 1-2 basis lower in early morning trading.

Moving to the other two major stories that have shaped this week's trading:

US Rates Outlook: Markets had largely brushed aside the chances that the Federal Reserve will follow through on plans to raise interest rates once more this year. But economic data released on Wednesday and Thursday has forced investors to reluctantly admit it might still be possible. The headline US inflation rate ("CPI") had undershot expectations for five straight months but accelerated to 1.9% in August, for once faster than forecasts, and up from 1.7% in July. A jump in gasoline and hotel prices following the destruction wrought by Hurricane Harvey was the main driver, but the "core" inflation rate, which strips out food and energy prices, was also unexpectedly strong, staying at 1.7%. Subdued inflation is the primary reason why investors have been sceptical the Fed would lift rates again. As such, the August inflation readings will be welcome ammunition for the Fed hawks. The odds for a rate increase by December 2017, as implied by Fed funds futures, have climbed from a low of just 20% last week to almost 48% today. Similarly, the 10-year Treasury yield duly edged up to 2.20%, the highest since August 22nd from as low as 2.015% last Friday.

The US central bank is likely to fire the starting gun on the reduction of the Fed's ballooning US$ 4.5 trillion balance sheet at its meeting next week (Wednesday, September 20th), and virtually no one so far is caring! Much more important will be those signals for future interest rate policy: Whether the FOMC majority stick to their plan of a rate hike in December (and 3 additional rate hikes in 2018 as per the current "dots" plot), and Janet Yellen places more emphasis in her statements on financial market stability (low market volatility, tightening credit spreads and rich equity valuations) against a backdrop of overly expansionary monetary policy are much more important questions.

In our view, the Fed's tightening path remains materially under-priced, with just one full 25 bps hike being priced into the market between now and the end of 2018. Together with the balance sheet wind-down that is likely to start in October or November of 2017 and will gain pace over time, an unprecedented rotation in the membership of the Federal Reserve Board – possibly including a new Chair and Vice Chair in early 2018 – as well as a fast changing monetary landscape in Europe, the next few months will surely bring higher market uncertainties and heightened market volatility (totally absent in past months!).

UK Rates & Currency Outlook: Although the Bank of England ("BOE") kept interest rates unchanged at its meeting on Thursday, it reminded traders and investors that they had been underestimating the probability of a hike this year! The minutes of the bank's Monetary Policy Committee meeting warned that "*some withdrawal of monetary stimulus was likely to be appropriate over the coming months in order to return inflation sustainably to target*." Bets on a rate increase at the December meeting soared, putting the likelihood at more than 60%. This hawkish message followed economic releases – out earlier in the week – that showed inflation running at 2.9%, well above the central bank's 2% target , as well the ILO unemployment rate moving to a 42-year low of 4.3% (from a peak of 8.6% in November 2011). Tightening policy to damp inflation risks exacerbating what Bank of England Governor Mark Carney warned would be a "squeeze" as income growth fails to keep up with price increases. To swing to a majority of five for a hike, three more members need to change their view (last decision was 7-2 in favour of keeping the UK benchmark rate unchanged at 0.25%). Additionally, Britons are not seeing the surge in wage growth that the fall in unemployment suggests they should be enjoying. The Brexit negotiations, meantime, remain fraught with danger.

Going into the meeting, traders and investors had placed a very low probability of such an outcome/message. As a result, the British pound immediately shot up and the market repriced higher the yield curve for U.K. government bonds.

It was reminiscent of what the Fed did last March when, through a well-executed sequence, it led markets to increase the probability of an impending rate hike from 30% to more than 90% in a remarkably short period of time. As of early afternoon, the British pound is trading close to 1.3600 (from 1.3200 prior to BOE announcement), whilst 10-year UK gilt yields hover close to 1.30% (they were trading slightly below 1.00% just a week back!).

The main question now is whether UK's monetary policymakers will walk the walk after putting on a good show of toughness, and more importantly whether other central bankers (the US Federal Reserve and Europe's ECB) would soon follow suit! Reminding markets/investors that they have become far too complacent about interest rates staying at rock bottom for ever is very important (mind blowing that Austria managed this week to issue a 100 year bond in the market with a coupon of 2.10% & a final maturity of 2117!); After all, leaving rates depressed - at a time of strong growth and easing financial conditions - always risks allowing imbalances and vulnerabilities in economies to build, even if inflation remains under control. However, recent history has also shown that words/market movements soon wane as traders realise that central bankers are loud from time to time, but there is no bite at all!

Central bankers have cried wolf on so many previous occasions, leaving markets currently more susceptible and less willing to place weight on newly made promises (the perfect recipe for a future financial disaster!). One can only hope that this time is different!

Disclaimer

It is important that you only use this report if you are the intended recipient of this report and you have satisfied yourself that you are eligible to receive such information. This report is provided to you because you are one of our esteemed customers and have previously shown interest in receiving the type of information contained in this report.

The Treasury and Investment Management department of Gulf International Bank B.S.C. ("GIB") have compiled the information in this report. GIB is incorporated in the Kingdom of Bahrain and is licensed by the Central Bank of Bahrain (the "CBB") as a conventional wholesale bank. GIB's head office is located at Al-Dowali Building, P.O. Box 1017, 3 Palace Avenue, Manama, Kingdom of Bahrain.

This report is intended for the accredited investors, as defined in the Investment Business Code of Conduct published by the CBB. This information has not been reviewed by the CBB or any other regulatory authority in any jurisdiction and neither CBB nor any other regulatory takes any responsibility for the correctness or accuracy for the information contained in this report.

The information contained herein is not directed at or intended for use by any person resident or located in any jurisdiction where (1) the distribution of such information is contrary to the laws of such jurisdiction or (2) such distribution is prohibited without obtaining the necessary licenses or authorizations by the relevant branch, subsidiary or affiliate office of GIB and such licenses or authorizations have not been obtained. The recipient of such information is responsible for ensuring that this information has not been received by it in breach of laws and regulations of any jurisdiction.

This report contains publicly available information only, which has only been complied by GIB. The information provided herein is on "as is" and "as available" basis and without representation or warranty of any kind. GIB hereby disclaims any representation or warranty, express or implied, as to the accuracy, timeliness, completeness, merchantability, fitness for any particular purpose or non-infringement of any of such information. In no event shall GIB or its subsidiaries, affiliates, shareholders or their directors, officers, employees, independent contractors, agents and representatives (collectively, "GIB Representatives") be liable (1) for any inaccuracy, delay, loss of data, interruption in service, error or omission or for any damages resulting there from, or (2) for any direct, indirect, incidental, special, compensatory or consequential damages arising from any use of information or arising from any error (negligent or otherwise) or other circumstance or contingency within or outside the control of GIB or any GIB Representative, in connection with or related to obtaining, collecting, compiling, analyzing, interpreting, communicating, publishing or delivering any such information. The information here is, and must be construed solely as, compilation of information (unless expressly stated otherwise) and not statements of fact as to credit worthiness or recommendations or opinions of GIB.

This report does not provide individually tailored investment advice. Any materials contained herein have no regard to the specific investment objectives, financial situation or particular needs of any specific recipient. The document is provided for information purposes and is not to be construed as a solicitation or an offer to buy or sell any securities or related financial instruments. GIB makes every effort to use reliable, comprehensive information, but we do not represent that it is accurate or complete. No representation or warranty, either express or implied, is provided in relation to the accuracy, completeness or reliability of the materials, nor are they a complete statement of the securities, markets or developments referred to herein. Recipients should not regard the materials as a substitute for the exercise of their own judgement. Any opinions are subject to change without notice and may differ or be contrary to opinions expressed by other business areas or groups of GIB as a result of using different assumptions and criteria. GIB is not under any obligation to update or keep current the information contained herein.

The value of, and income from, your investments may vary because of changes in interest rates or foreign exchange rates, securities prices or market indexes, operational or financial conditions of companies or other factors. Past performance is not necessarily a guide to future performance. Estimates of future performance are based on assumptions that may not be realised.

The information contained in this report is just for informational purposes. Information does not constitute a solicitation, an offer, or a recommendation to buy or sell any investment instruments, to effect any transactions, or to conclude any legal act of any kind whatsoever. GIB does not intend to provide investment, legal or tax advice through this report and does not represent that any securities or services discussed are suitable for any investor. When making a decision about your investments and business, you should seek the advice of professional advisors.

The report may contain statements that constitute "forward looking statements". While these forward looking statements may represent GIB’s judgment and future expectations, a number of risks, uncertainties and other important factors could cause actual developments and results to differ materially from GIB’s expectations. GIB is under no obligation to (and expressly disclaims any such obligation to) update or alter its forward-looking statements whether as a result of new information, future events, or otherwise. The historical information is provided for information purposes only. Performance figures are calculated before tax (if any) and after deducting ongoing fees and expenses. The performance figures are historical and past performance is not necessarily an indication of future results. Certain amounts (including %ages) included in this document may have been subject to rounding adjustments. Accordingly, figures may not be an exact arithmetic aggregation of the figures to which they relate. The values and forecasts shown represent our current indicative valuations and forecasts of the relevant transactions, currencies, interest rates, commodities or securities as at the date shown. Any value or forecast shown herein is not an indicative price quotation. We expressly disclaim any responsibility for the accuracy of the values or forecasts shown, any errors or omissions in the report

With the exception of information regarding GIB and save as otherwise specifically indicated, the information set out in this report is based on public information. We have, where possible, indicated the primary source of information. We strongly recommend the recipients consult the primary source of information. Facts and views in this report have not been reviewed by, and may not reflect information known to, professionals in other GIB business areas.

This Report, and the information contained herein (save to the extent that such information is publicly available) is confidential and may not be disclosed by you to any other person outside of your organization without our consent.

GIB retains all right, title and interest (including copyrights, trademarks, patents, as well as any other intellectual property or other right) in all information and content (including all text, data, graphics and logos) in this document. All recipients must not, without limitation, modify, copy, transmit, distribute, display, perform, reproduce, publish, license, frame, create derivative works from, transfer or otherwise use in any other way for commercial or public purposes in whole or in part any information, text, graphics, images from this document (excluding publicly available information) without the prior written permission of GIB.