Weekly Market Summary

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Disturbing Developments & Persisting Insanity at the White House!! Is it Time for a Full-Blown Risk-Off Trade?!

Fadi Nasser - Deputy Chief Investment & Treasury Officer

At a GIB gathering earlier this week, and whilst providing a summary update on financial markets, I did note that the growth outlook for 2018 remained quite favourable, with the stars aligned for a continuation of the positive above-trend global growth, and a low but gently rising inflation. Additionally, easier financial conditions, coupled with fiscal stimulus, could only lead to - at least in my mind - sustained economic development over the coming year. Those views were very much in line with earlier economic assessments/projections by the International Monetary Fund (IMF) and the World Bank, who hailed the "*broadest synchronised global growth upsurge since 2010*", as well as a brightening outlook and a "*solid cyclical recovery, reflecting a rebound in investment, manufacturing activity, and trade.*" Nonetheless, I was also quick to point out that what "*everyone knows or assume to know*" is usually unhelpful at best and wrong at worst, especially when it comes to predicting future asset moves and general market trends. As such, investors would always be better-off analysing - in details - impending risks to the bullish consensus outlook, including those uncertainties relating to the impact of the normalization of monetary policies in advanced economies, the possibility of a stock/emerging markets sell-off and credit spreads widening (in other words, a resurgence of financial stress), increased protectionism and intensifying political/geopolitical tensions … That is not to forget the persisting political fiasco at the White House/within the US administration and Trump's regular misdeeds, scandals and reckless tweets!

After all, 2017 had been a near-perfect year for risk assets with both equities and emerging market bonds producing relatively high returns amidst low market volatility and the road ahead in 2018 would almost certainly be more uncertain and challenging - with volatility expected to stage a strong comeback; Hence the ultimate revival of the "*Risk-On/ Risk-Off*" trade! As a refresher, "*Risk-On*" refers to the reflation trade, the idea that the global economy is in recovery. Usually such trades follow positive market developments, such as strong economic releases, monetary easing by central bankers or fiscal stimulus by governments. As a result, equities, credit and commodity markets rally, whilst fixed-income markets (US Treasuries, German Bunds or UK Gilts) are hardly hit. "*Risk-Off*" is the reverse: Traders want safety and look for it in US & European government bonds, Japanese Yen or Swiss Franc. Market participants want to avoid commodity currencies and equities for fear of lower global growth. US bond yields tend to fall in a risk-off environment, as investors move out of high yielding bonds into the safety of "low risk" bonds (flight to quality).

Though little did I foresee the Risk-Off trade kicking-in so early in the year!!

Almost a little more than a year after being sworn in as the new US Secretary of State (February 1st 2017), and several months after calling his boss a total "*moron*" (for the right reasons, I am guessing! ☺) – even though such claim was categorically denied by Tillerson last summer, who said "*I'm not going to deal with petty stuff like that*" and added "*it is intended to do nothing but divide people*" - President Trump announced in a tweet last Tuesday that he had ousted his Secretary of State (the official phone call came only 3 hours later!) and plans to nominate CIA Director Mike Pompeo to replace him as the nation's top diplomat, orchestrating a major change to his national security team amid delicate outreach that includes possible talks with North Korea and interventions in Syria. Trump and Tillerson have had a fraught relationship for many months (the latter even taking a nickname, "Rexit"), and the US president blamed his decision on disagreements over strategy in key areas of foreign policy, such as the 2015 Iran nuclear deal, the approach to North Korea and the overall tone of U.S. diplomacy. "*I actually got along well with Rex, but really it was a different mind-set, a different thinking," Trump said Tuesday as he departed the White House for a trip to California. "When you look at the Iran deal, I think it's terrible. I guess he thought it was okay . . . . So we were not really thinking the same. With Mike, Mike Pompeo, we have a very similar thought process. I think it's going to go very well*." Tillerson, on the other side, thanked career diplomats for their "*honesty and integrity*" and the American people for "*acts of kindness*," singling out Defence Secretary Jim Mattis for their partnership and mutual support of diplomacy. But he notably did not thank Trump or praise his policies (how surprising!?).

Hours later, the undersecretary of state for public diplomacy and public affairs – Steve Goldstein – was also fired after claiming that Tillerson was "*unaware of the reason*" for his firing and had not spoken directly with Trump, only "*finding out that he was terminated on the same day*." Overnight, the Washington Post reported that Trump had decided to remove White House national security advisor H.R. McMaster from the administration, though the White House subsequently denied there are changes coming to the National Security Council. The Wall Street Journal subsequently confirmed the report, adding that timing of the move is unclear but could be months away (my guess is that we now wait for the next presidential tweet ☺).

Elsewhere, in the UK, Prime Minister Theresa May has thrown 23 Russian diplomats out of Britain in retaliation for the poisoning of a former spy and his daughter with a "military grade" nerve agent known as "Novichok" on U.K. soil , as she braced the country for further attacks (perfect timing for the Natixis economics team, who recently produced a piece in relation to what would happen should investors become "fearful" again – namely switching to risk-free bond, underweighting risky assets and moving into safe haven assets such as gold… not to mention propping up weak and unpopular politicians, if you ask me!). May said the U.K. will move to freeze Russian state assets where necessary in response to what she called an "*unlawful use of force*" involving a weapons-grade nerve agent against the UK. The crisis is a key test for the British prime minister and comes at a critical time in the country's history, as she navigates the U.K.'s exit from the European Union. The Russian Embassy in London was quick to denounce the expulsions - the biggest for more than 30 years - as "*totally unacceptable, unjustified and short-sighted*." Similarly on the streets of Russia, very few were able to make sense of the official British version. "*What reason would Russia have to do this?"* "*Why now, just days ahead of Putin's assured re-election to a fourth term in power"*; "*Why use a Soviet nerve agent that can be traced back to Moscow?"; "Why attempt to kill a double agent who was traded years ago and no longer of any use?".* Even U.K. Labour Party Leader Jeremy Corbyn warned May against sparking a new cold war. Writing in the Guardian on Friday, Corbyn said "*a connection to Russian mafia-like groups that have been allowed to gain a toehold in Britain cannot be excluded … To rush way ahead of the evidence being gathered by the police, in a fevered parliamentary atmosphere, serves neither justice nor our national security*," Corbyn noted (He has come under immediate fire from his own MPs over those latest statements!).

Last, but not least, for readers solely focused on economic and monetary developments, the US Federal Reserve is expected - next week - to raise the o/n fed funds rate by 25 bps (from a range of 1.25% - 1.50% to 1.50% -1.75%), even though the March 21st FOMC meeting is turning into a sideshow amid a relentless move higher in the London Interbank Offered Rate ("LIBOR") as well as other money-market benchmarks. With a quarter-point Fed hike largely priced in by the overnight index swaps market (an OIS swap is an interest rate swap involving the overnight rate – usually the actual federal funds rate on that particular day, which could be slightly different from the targeted rate - being exchanged for a fixed interest rate), all eyes are now on the surging USD LIBOR and its spread over the OIS rate. A spread known as FRA/OIS - which measures market expectations for the Libor/OIS gap - this week breached 50 bps for the first time since January 2012 and extended through 52 basis points on Thursday (that spread has historically averaged some 16 bps only!). Three-month dollar LIBOR jumped 3.25 bps yesterday to 2.17750%, the highest since 2008. Some analysts are wondering whether the events in the money market are going to draw the attention of policy makers. Also yesterday, Saudi Arabia pre-emptively raised its key interest rates ahead of the upcoming Fed decision. The Kingdom increased its repurchase and reverse repurchase rates by 25 basis points each, to 2.25% and 1.75% respectively, the Saudi Arabian Monetary Authority, known as SAMA, said in a statement. While the reverse repo rate has been raised over the past two years in step with U.S. rate changes, it is the first time the Kingdom has changed the repo rate since 2009. The move comes as Saudi interbank rates, for the first time since the global financial crisis in 2009, are below their U.S. dollar equivalent in London. On Thursday, the difference was 14.5 basis points. Economists say the discount could result in capital outflows or deposits being shifted from Saudi riyals to U.S. dollars. "*The rate hike represents a change of track for SAMA which tended to follow rather than pre-empt the Fed*," said Ziad Daoud, chief Middle East economist for Bloomberg Economics. "*The move is probably motivated by concerns over the risk of capital flight as the Saudi 3-month interbank rate continued to fall below its U.S. counterpart*." Saudi Arabia follows U.S. monetary policy because its currency is pegged to the dollar. Historically, borrowing rates in the Kingdom have been higher than those in the U.S. – roughly around 50 bps, though as high as 150 basis points in mid/late 2016! Last week, the central bank suspended the use of 7-day, 28-day and 90-day repurchase agreements that were rolled out during the liquidity crunch two years ago. However the spread between Saudi interbank rates and the U.S. dollar equivalent continued to gradually widen. "*We see this move by SAMA as an attempt to remove the discount*" between the rates, said Monica Malik, chief economist at Abu Dhabi Commercial Bank. "*Moving ahead of the Fed indicates a commitment to raise rates*."

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