Weekly Market Summary

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2017 Coming to an End: The Year of Market Boredom, Low Inflation, Tax Cuts and Few Geopolitical Surprises.. Not to Forget Bitcoin!!

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When history looks back at 2017, a couple of words will stick out most prominently: Very low inflation and market volatility, last minute US tax cuts, North Korea's persisting tensions and few Middle Eastern surprises .. Not to forget Bitcoins!

2017 will be remembered as the year when the textbook connection between inflation and unemployment broke down (also known as the **Phillips Curve**, an economic concept that asserts inflation and unemployment have a stable and inverse relationship: Stated simply, decreased unemployment in a growing economy will correlate with higher rates of inflation). If economists missed unemployment to the high side (median forecast for year-end 2017 stood at 4.6% versus a current reading of 4.1%), you would think they would miss inflation to the low side, right? Wrong. Welcome to the "*mystery*" of 2017, as described by Federal Reserve Chair Janet Yellen during recent speeches. That caught just about everyone by surprise as inflation remained disturbingly low at 1.5% (core PCE) in the 12 months through November, against surprisingly strong job gains. "*We can definitely learn from that*," noted Christopher Low, chief economist at FTN Financial in New York, who was among the best predictors of inflation (and among the worst on unemployment!). "*The thing we're looking at here now is trying to understand where the inflation-unemployment relationship broke down*." Stephen Gallagher, chief U.S. economist at Societe Generale SA in New York, said he doesn't think it is a one-year phenomenon, but rather something of a new paradigm. Those views are surely shared by traders in the market place, who have pushed the US yield curve to its flattest level in more than a decade: The spread between the yields on 2-year and 10-year US Treasuries narrowed to just 50.6 basis points on Wednesday, close to the low reached on December 6th. Whether or not this flattening pressure eases somewhat as we go into next year remains one of the biggest market uncertainties/bets for 2018!

In three decades since the CBOE Volatility Index was invented (we refer to it as the **VIX index**, a popular measure of the stock market's expectations of volatility implied by S&P 500 index options), 2017 will also go down as the least exciting year for stocks on record, with the VIX's average level around 11.10, about 10% lower than the next-closest year (despite a yearly rally in equities that is little short of spectacular, with a 20%+ YoY jump in equity indices). It would be tempting to say nobody thinks it will last, but that would be to ignore the walls of money that remain stacked up in bets that it will. Hundreds of billions are betting against beta (a measure of the volatility, or systemic risk, of a security/portfolio in comparison to the market as a whole) in things like volatility futures, and the global short volatility trade currently has more than $2 trillion in various strategies, according to an October report by Christopher Cole, the founder of Artemis Capital Advisers hedge fund. He compared the strategy of betting that volatility, already near record lows, will fall even further, to a snake "*blind to the fact that it is devouring its own body*." Indeed, anyone in a short-volatility position should be aware that when the end game comes, it usually comes fast! Investors see a 74% probability that equity price swings will widen next year as the current levels of volatility are "*unsustainable*," according to a survey of 229 investors representing $6 trillion in managed assets conducted by Absolute Strategy Research.

On the legislative front, the Tax Cuts and Jobs Act ("TCJA"), passed by both Houses of the US Congress earlier this month, got signed into law by the man himself, Mr. Trump, last Friday December 22nd. Its highlight is the slashing of the US corporate tax rate to 21% effective next year, from the current top rate of 35%, coupled with temporary tax cuts for most individuals. Those tax cuts are widely seen by a majority of the US public as likely benefiting large corporations, the super-rich, Wall Street investors and big political donors. They are also expected to add to US fiscal deficits to the tune of 0.6% of GDP per year, according to the Congressional Budget Office, as well as to debt (to the tune of $1.5 trillion over 10 years). Still, the tax bill is the most significant legislative victory for the US President, who has struggled during his first year in office to pass major bills that would deliver on campaign promises, even with Republicans having the majority in both chambers of Congress.

Turning to geopolitical worries, tensions have remained high on the Korean peninsula, as well as across the Middle East. How concerned should investors be on this front, heading into 2018? Anyone's guess really! Throughout the year, President Trump has threatened to "*totally destroy*" North Korea if his country is forced to defend itself or its allies. North Korea – on the other side - has conducted its sixth nuclear test, threatened to fire off missiles towards the US island territory of Guam and said it might test a hydrogen bomb in the Pacific Ocean. And all this has come amid reports that Pyongyang may have finally succeeded in miniaturising a nuclear weapon that could fit on an inter-continental missile - a prospect long dreaded by the US and its Asian allies. Is this a precursor to military conflict, as early as next year? Experts say investors should not panic - just yet, for the following reasons:

1. Nobody wants war: This is one of the most important things to keep in mind. A war on the Korean peninsula serves no-one's interests. In fact, this is why North Korea has been trying so hard to become a nuclear-armed power. Having this capability, it reasons, would protect the government by raising the costs of toppling it. Kim Jong-un does not want to go the way of Libya's Muammar Gaddafi or Iraq's Saddam Hussein.
2. What analysts are seeing are words, not actions: President Trump may have threatened North Korea with language uncommon for a US president but this does not mean the US is actively moving on to a war footing. As one anonymous US military official told Reuters news agency back in August: "*Just because the rhetoric goes up, doesn't mean our posture changes*."
3. We have been here before: As former US Assistant Secretary of State PJ Crowley points out, the US and North Korea came close to armed conflict in 1994, when Pyongyang refused to allow international inspectors into its nuclear facilities. Diplomacy won out. Over the years, North Korea has regularly made incendiary threats against the US, Japan and South Korea, several times threatening to turn Seoul into a "sea of fire". And Mr Trump's rhetoric - in content, if not style - is also not exactly unprecedented from a US president.

Regionally, a well-advertised visit by Mr. Tump to Saudi Arabia - in late May - for a summit with Arab leaders was quickly followed with a new and shocking reality on the ground: Early morning on June 5th, four Arab nations opted to cut diplomatic ties to Qatar over what they perceived as their neighbour's "*strong relations with Iran and support of various terrorist and sectarian groups aimed at destabilizing the region*", isolating the small energy rich country by cutting-off its land, sea and air routes to the outside world. Saudi Arabia, the United Arab Emirates, Bahrain and Egypt also chose to start withdrawing their diplomatic staff, ordered their citizens out of Qatar and gave Qataris abroad 14 days to return home to their peninsular nation. The countries also said they would eject Qatar's diplomats from their territories as regional airlines quickly announced they would suspend service to its capital, Doha. Qatar was quick to criticize the move as a "*violation of its sovereignty*", denying it had supported militant groups during the "Arab Spring" and describing the latest crisis as being fuelled by "*absolute fabrications*" stemming from the recent hack of its state-run news agency. The crisis – now in its six months – appears to have no quick fixes in sight, with various mediations by the Kuwaiti Emir and US Secretary of State (Rex Tillerson) failing to bring antagonists together. In recent weeks, Mr. Trump has added fuel to the Middle East fire – defying warnings from allies across the world and overturning decades of US foreign policy - by announcing that he is recognising Jerusalem as the capital of Israel, and triggering plans to move the US embassy there, from Tel Aviv. The US president has described the step as a long overdue move that would advance the peace process (Oh yeah, u bet!), and declared the US would support a two-state solution for the Palestinians and Israelis should they embrace such an outcome.

And then there was BITCOIN!!!

Perhaps no investing idea attracted more attention in 2017 than cryptocurrencies, from Jamie Dimon's dismissal to Katy Perry quizzing Warren Buffett about the subject! Bitcoin soared almost 1,700%, while smaller counterparts such as Ethereum and Litecoin gained at least 5,000%. Of course, those surges were accompanied by no shortage of pessimists calling the move a bubble (count me in! ☺).

After all, it is clear that major central banks around the world have managed their monetary policies - for the past 15 years now - in an extremely questionable manner: Keeping short term rates abnormally low and maintaining highly expansionary monetary policies, even at full employment; Considerably increasing liquidity in the market place; Allowing the bursting of asset price bubbles (in fact, officials were totally clueless when those materialized!); Building excessive debt. That explains why our weekly market updates have – on several previous occasions – criticised those same central bankers for their destabilising behaviour, their manipulation of financial markets and their distortive monetary policies.

To many market players, frustration arising from these disrupting official policies led to the desire for a form of currency that is not under the control of governments and central banks, and which escapes their destabilising behaviour: Bitcoin could have possibly emerged as a result of this desire, with a Bitcoin creation process (money supply) that is algorithmic and exogenous and cannot be controlled by governments and central banks (though I still find it extremely hard to believe that an Australian entrepreneur named Craig Wright – alias Satoshi Nakamoto – was behind the bitcoins' design and the creation of its original reference implementation. Maybe one day, historians would look back and label bitcoins as the initial "New World Order" breakthrough virtual currency put in place by the Rockefellers/Rothschild and the world elite ☺).

But the cure is turning out to be worse than the disease: Since the supply of Bitcoins is exogenous, the increase in demand for Bitcoins has driven up its price considerably, creating a bubble that is also extremely destabilising. The price of a financial asset whose supply is not adjusted according to demand can go to any level: $1, $100, $1,000 , $ 10,000 or $ 100,000! We will soon know what market players have in mind for the coming year.

Once again, many thanks to all GIB's clients for your continuous support throughout 2017! Best of luck navigating markets in 2018!!

I will be away for the coming 10 days and resume my regular market updates in mid-January. In the meantime, feel free to get in touch with the Treasury Sales team at GIB for all your Treasury needs, as the gentlemen on the Desk will surely be around at all times to assist (by e-mail Trsy.Sales.bh@gib.com) or by phone (+973 17511511)).

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