International scene

Fed hike not due till late this year, strong dollar helping Europe but slowing US exports

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While markets and volatility were primarily driven by collapsing oil prices in late 2014, the baton shifted this year to the US dollar. The US dollar, which rose slowly most of last year, jumped higher in a sudden burst during the past month or two. The strong dollar, which had contributed to lower oil prices, is currently up 25% against the euro's high of 1.40 in 2014, 15% of which came in a matter of short weeks (it corrected slightly since). The long awaited dollar rise finally came together when the ECB announced QE (quantitative easing) and acted upon it this March. Of course, fundamentals, both economic and political, had been in the dollar's favor for quite some time but the tight-compared-to-the-Fed ECB kept slowing or postponing any significant dollar rally, until recently.

The ECB finally started its QE purchases in March, at euro 60 billion per month for the upcoming 18 months or for a potential total of euro 1.1 trillion. With the Greece situation off the headlines for now, and somewhat better-than-expected data recently, the eurozone is expected to be already benefiting from lower oil prices, and is expected to get further mileage from the much weaker euro, in the form of faster export and GDP growth. Real GDP growth is projected in the 1-1.5% range this year and next. In other words, stability, and slight improvement in growth with plenty of liquidity, courtesy of QE, is expected to pressure the euro further while providing support to European equity markets. The hope is also that a sustained deflation scenario will be avoided.

The ECB action is expected to finally put the eurozone in a place similar to where the US was a few years back, when it embarked early on its different QE programs. Note that at the time, the US was facing lower unemployment and less deflationary pressure than the eurozone is facing today, which is why the 10-year US Treasury never got as low as the miserable 25 bps currently earned on 10-year German Bunds. The latter is one of the reasons US rates are expected to rise, though only very gradually, this year as the spread to US rates have become gaping, at almost 200 bps in favor of the US for similar quality credit. Also, and although the Fed removed the reference to "patience" from its March policy statement (as-expected), it signaled in different ways that it remains very cautious: its members' economic and interest rate forecasts were revised down, pointing to a Fed hike rather late in the year.

World growth is anticipated at 3-3.5% by most, and a bit higher by the IMF. Recently, forecasters are tinkering with the major economies' forecasts with little change to the big picture. So, "sideways" it is for Japan where the BOJ may have to do more QE. A tick or two higher for eurozone GDP. A tad lower for the US, as recent weakness in retail sales and manufacturing was further exacerbated by a weak March jobs report; the economy added 126 thousand new jobs and unemployment

stayed at 5.5%. Though some of the weakness in Q1 relates to the cold weather and a major ports strike, it does seem that the stronger dollar and a cautious consumer are affecting growth. The Fed has cited the strong dollar as an area of focus if not concern.

In the above picture, the Fed is expected to start raising interest rates very slowly and gradually in September or even later this year. The patience, or wait, is afforded the Fed thanks to the low inflation/deflation environment in the US (in particular wages) and by the strong dollar that adds to deflationary pressure and hurts US exports and growth, especially in a fragile world context.

Like last year, the big risk, besides a slower than expected US (say sub-2.0% growth), is a much weaker than expected China. The Chinese government, after a long delay, revised down its target and forecast for this year to 7%. It is also vowing to act aggressively, should there be signs of missing the target, not exactly a vote of confidence. Chinese inflation at about 1.5% is running at half the (lowered) target of 3.0%. Talk of renminbi appreciation, prevalent the last two years, has faded, and the risk is for a somewhat lower renminbi, at least near term.

While lower oil prices have raised concerns about the GCC countries, major oil exporters, we contend that the impact on the economies in the next 2-3 years will be relatively muted and that real growth should remain well supported in the 5-6% range for the non-oil side of these economies. Recent Markit PMI data from Saudi Arabia and the UAE, show continued strong and steady growth in their non-oil sectors. The March overall index was at 60.1 for Saudi Arabia and 56.3 for the UAE. The need to diversify, and to build and improve their infrastructures, remains high and the ability to finance is not in doubt for the major GCC countries, all of which have very high levels of reserves and very low debt levels.

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