Treasury Group

Weekly Money Market Report

05 February, 2017

The Fed in the Passenger Seat

United States

Attempting to Curb the Dollar Strength

The second week of the new President continued on the same incendiary tone with the new administration attempting to curb the US dollar strength by blaming the usual perpetrators.
It was German politicians turn this time to take heed as the head of the White House new National Trade Council; Peter Navarro accused them of using a “grossly undervalued” Euro to “exploit” the US and other EU members. He added that the Euro was like an “implicit Deutsche Mark” whose low valuation gave Germany an advantage over its trading partners, and added that Germany was one of the main hurdles to a US trade deal with the EU.
Germany responded on the spot and reject the criticism stating they “won’t exercise any influence over the European Central Bank”, as they “strive to trade on the global market with competitive products in fair trade with all others.”

On the economic front, as the first Fed meeting in 2017 was a non-event, markets have quickly turned their attention to President Trump's first State of the Union address on February 28 for clues of what is coming next and who will be the next victim. In addition, as the second Fed meeting of the year will be two weeks later, there will still be considerable uncertainty as to what would the fiscal policy look like under the new administration. This is why the Fed would likely prefer to stay in a waiting mode and not hike rates until more clarity is provided as to the potential Trump fiscal stimulus. In the event that economic data disappoint, a hike as soon as March or even at a non-press conference meeting in May would be ruled out and could potentially hurt the USD without the need of Trump making additional complaints.

The main highlight of the week on the other side of the ocean was February’s Bank of England quarterly inflation report and the latest decision of the MPC. As expected, the BoE unanimously kept its policy unchanged, while retaining a neutral forward guidance on interest rates. Inflation forecasts for the years ahead were unchanged for 2017 but lowered for 2018 and 2019. According to the report, while UK consumer spending is likely to drive higher than expected growth in the next few quarters, personal consumption risks are rising in the long term.

On the foreign exchange side, the USD ended the week relatively unchanged as January Fed meeting was a nonevent.

The Euro opened the week at 1.0683 and reached as high as 1.0829 on continuous positive Euro zone data. Although the dollar’s recent correction can be largely explained by the retreating US yields, the news that French presidential candidate Francois Fillon is facing new claims that his wife and children received public funds for fake jobs, continue to hurt his campaign and gave his opponent Le pen an edge in the survey pools. The Euro slightly Retreated on the news however closed the week near the highs at 1.0787 despite the positive Job reports out of the US.

The Sterling Pound started a strong week around the 1.25 level and reached as high as 1.2706 trading on the positive investors’ mood over May's first US visit and a potential trade deal agreement with its US counterpart. The currency pushed to the highs on the headline that some MPC members signaled increasing concerns about inflation, but then the pound fell back more sharply as the text made clear that the BoE was more concerned with the negative household income effect of higher import prices and its likely effect on inflation expectations. The currency closed the week at 1.2485.

The Japanese Yen continued to range trade this week on the back of the US dollar correction. After opening the week around the 113 level, the currency closed the week at 112.57.

On the commodities side, oil continues to trade in a relatively narrow range well above the $50 per barrel fairly close to the eighteen months high. Gold prices also traded in a small range from as low as 1,190 to close the week at $1,220.

FOMC Provides Few Clues

The Federal Reserve was able to achieve major milestones this week. Indeed it was able to acknowledge economic improvement, avoid political interference with the new administration and provide some optionality on a March rate hike. In details, the FOMC statement slightly upgraded assessments of the current economy but made no significant changes to the economic outlooks. On the employment front, the FOMC tweaked its statement and said that the unemployment rate "stayed near its recent low". In comparison, the Fed said in December that the jobless rate "has declined".

The statement also included one important change, a line added to note that business and consumer sentiment had improved of late. Members however did not feel compelled to make a move near-term as there were no signs in the statement for a potential move in March.

In summary, the market continues to expect two 25 basis points hikes this year; however the dot plot shows that Fed seems more optimistic as members are still thinking about three hikes this year. A potential move in June, September and December seems more likely if these expectations materialize.

Healthy US Job market and Strong Vehicle Sales

January's nonfarm payrolls came above expectations at 227k compared to expectations of 175K. Strong gains were in construction up by 36K and Retail up by 46K. Being volatile in nature, these two industries always tend to raise analysts' suspicions as to whether they would draw a conclusion on the state of the US strong employment.

Unemployment rate on the other hand rose to 4.8% in January from 4.7% in December. And wages increased by 0.1% on a monthly basis in January and the February increase was revised to 0.2%. The annual increase now stands at 2.5% in January.

The overall labor participation rate rose to 62.9 in January from 62.7 in December and was a key factor raising the unemployment rate. Labor participation climbed for workers between 20-44 years of age. These added measures are suggestive that potential workers are finding desired full-time jobs and should ease Fed members mind as to their dot plot projections for 2017.

On a different front, US vehicle sales declined. Light vehicle sales fell to 17.5 million units, compared with 17.8 million in the previous year. According to the report, December, fueled by record incentive-spending by auto makers, was among the best months for U.S vehicle sales in history, helping the industry set a second-consecutive annual sales record. Auto makers are planning to build slightly more vehicles in North America in the first quarter than the same period a year ago, signaling continuous optimism for 2017.

Europe & UK

Political Risks despite Strong Fundamentals

During the past two months, the Euro zone has continuously shown signs of improvement, with the service sector PMI figures coming at 53.7 from the 53.6 preliminary estimates. The final composite PMI came in at 54.4, also higher than the estimate of 54.3. Combined with modest signs of inflation beginning to pick up, this will keep the debate going within the ECB over the potential timing of their additional QE tapering.

Despite the strong data releases happening lately, political risk premium remain highly priced in the Euro zone. As the French election seems to be the straw that could break the camel's back, if Le Pen does win the presidential election, we would expect the focus on Eurozone breakup risks to increase and the fundamental economic figures to deteriorate rapidly.

According to Le Pen's advisor, her program explicitly foresees re-establishing the possibility for the French state to refinance itself at the Bank of France," and that "One shouldn't obsess over inflation." A return to the franc would mean all of France's existing public debt of about 2 trillion Euros would be redenominated in the new currency. Moreover, according to her plan, there will be six months of negotiations to take France out of the Euro. She would also reinstate border controls and essentially seek an overhaul that would reduce the European Union to a very loose cooperative of nations. "Our preferred scenario would be to agree jointly on the dismantling of the Euro zone"

"Brexit" Scenarios Remain Vague

The Inflation Report out of this week saw the BoE re-iterating their view that the monetary policy can respond in either direction to the future economic situation resulting from the "Brexit" negotiations. Despite the upside revision to near term growth, inflation forecasts were largely unchanged. While this afforded the MPC room for now, continued growth would strongly test their tolerance for above target inflation. The report also pointed out that non-resident inflows have shown signs of moderating in the latest data.
Last but not least, the report showed the bank's concerns that higher spending will be driven by de-saving, as it fears that "continued moderation in pay growth and higher import prices following sterling's depreciation are likely to mean materially weaker household real income growth over the coming few years."

Asia

China's Figures Showing Signs of Stability

China's January manufacturing PMI came at 51.3 against expectations of 51.2 and December's 51.4. Recent PMIs figures continue to signal expansion in China's manufacturing sector, and hence in China's commodity demand. While the official PMI tend to focus on larger companies; the private China Caixin PMI also released this week slowed in January from December, but continued to show the economy was recovering. The figure came in at 51.0 in January, down from 51.9 in December. According to the report, "the rate of improvement slowed since December, as output and new orders increased at weaker rates amid a further reduction in employment. At the same time, inflationary pressures remained sharp, with both input costs and output charges increasing at rates hardly seen throughout the past five years"

Japan Trying to be on the Right Side

This week, the BoJ left its monetary policy unchanged and maintained its government bonds purchase target at JPY 80 trillion per year and price target for the 10year government yields at 0%. The central bank indicated that it will continue with QQE with Yield Curve Control as long as is needed to hit its inflation target. On a positive note, the BoJ upgraded its GDP forecasts to 1.4% from 1.0% for 2016, and from 1.3% to 1.5% for 2017. It also lowered its inflation forecast to -0.2% from -0.1% for 2016, and left its forecasts for 2017 at 1.5%.

On a different front and in a response to the US president, Japan's Chief Cabinet Secretary said on Wednesday that FX rates were decided by the market and were not being manipulated by the Japanese government. "As Bank of Japan Governor has said repeatedly, Japan's monetary policy aims to achieve the domestic purpose of ending deflation. It's not aimed at affecting currency rates."

In an attempt to sweeten the relation, reports this week showed that Japan's Government pension fund will purchase debt issued by American corporations to finance infrastructure projects. The report noted that up to 5% of the roughly JPY130 trillion in assets controlled by the fund can go toward overseas infrastructure projects, and that currently, only tens of billions of yen are invested in that asset class.

Australia Enjoying a mini Commodities Honeymoon

The December trade surplus surged much more than expected to a record 3.5 billion Australian Dollars. According to the report, higher commodity prices saw export values increase dramatically at the fastest pace since 2010. Meanwhile, services slowed to a flat trend although remain at an increase of 8% on a yearly basis. Elsewhere, import values remained flat an increase of 1% on a yearly basis still the strongest in a year. The soaring commodity prices have led to a nominal export increase of 32% over the year, which combined with flat imports, delivered a record trade surplus.
On a different front, residential building approvals dropped by 1.2% in December and by 11.4% on a yearly basis. The monthly fall was entirely driven by private houses falling to the lowest level since 2013. The value of non-residential building approvals was also flat after dropping in recent months and showing signs of exhaustion of money inflow from Chinese investors moving money out of the mainland.

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Kuwait

Kuwaiti Dinar at 0.30470

The USDKWD opened at 0.30470 on Sunday morning.

Rates – 05 February, 2017

	Previous Week Levels				This Week's Expected Range		3-Month
Currencies	Open	Low	High	Close	Minimum	Maximum	Forward
EUR	1.0689	1.0617	1.0828	1.0781	1.0615	1.0995	1.0832
GBP	1.2548	1.2410	1.2707	1.2485	1.2335	1.2710	1.2520
JPY	115.08	112.03	115.13	112.70	110.70	114.85	112.35
CHF	0.9985	0.9857	0.9985	0.9924	0.9725	1.0115	1.0832