**International scene**

**Fundamentals and markets steady, risks still small but rising in US**

Low volatility has been the story in the financial markets so far this year, equities in advanced economies in particular. (Chart 1.) Unprecedented events, such as Mr. Trump assuming office early in the year or the election in May of a relatively unknown in France in Mr. Macron, have left the markets relatively unfazed. Many factors may account for the low volatility, including technical reasons, such as the heavier reliance on passive-based investments (index funds, ETFs, etc.). Fundamentals, however, have also had a major role. We noted last month that the major economies, and thus their policy environments, had been remarkably stable for quite some time. I.e. steady growth worldwide, accompanied by gradual small upside surprises (primarily EU) leading to mild revisions upward, all accompanied by stable inflation that is in line with most central banks’ expectations. In other words: nothing conducive to any major economic or policy reassessment. That may be about to change.

For now, early June, most equity markets are up on the year and nicely so, some hitting historic highs. Equities in advanced economies are up over 8% ytd; world markets are up some 9% ytd while emerging markets are up about 13%. The GCC are lagging significantly, down 2.3% ytd, after significant rallies by some late in 2016 (Saudi) or early in 2017 (Kuwait). (Chart 2.) In recent days, the Qatari trade and diplomatic flap with its GCC partners also started to take a toll on asset prices. Oil prices are not helping the region by struggling to hold $50 pb (Brent basis), notwithstanding a recent agreement by OPEC and its partners to extend their current output cuts by another nine months until March 2018. The outlook for oil prices is quite uncertain, with recent forecast revisions going both ways. We are staying with gradually higher prices ahead and an average price of $55 pb for Brent this year, based on further OPEC cuts, shrinking inventories and the upcoming travel and driving season.

Consensus projections of 3-3.5% for world growth this year appear reasonable. The US is expected to grow 2-2.5%, the Eurozone a little under 2.0%, China 6.5%+, plus, and Japan 1-1.5%. For these major economies and others, the data is coming in “steady”; in other words, with less volatility and fewer special factors than usual. (Chart 3.) The same can be said of the inflation data, in particular since oil prices and energy prices have been relatively well behaved so far this year. (Chart 4.) The Fed just hiked rates in June, and is expected by markets to hike rates once more this year.

The Fed is also expected to start “normalizing” policy further, by starting to bring down its enormous balance sheet ($4.3 trillion). The Fed should start, in December or earlier this year, to stop fully replacing maturing Treasuries in its portfolio. It would thus replace only a portion of maturing debt, letting the rest be subtracted from its outstanding portfolio. The ECB, which is still adding monthly to its portfolio (€60 billion monthly), will not discuss portfolio reduction yet, not even the prospect of raising rates, though that time is looming. Interest rates are still close to zero there, and the ECB still sounds very dovish, though in light of
better than expected data from Europe, the markets are already sensing what is coming, as gradual and as belated as it may be (2018).

Germany and Mrs. Merkel are not thrilled with the low interest rate policy either. They said or intimated that the euro currency was undervalued, thus pressuring the ECB for its next move; this at a time when pensioners and savers have all but lost patience with near-zero returns on their fixed income investments. Japan’s rates are, of course, still close to zero (10-year note, yields 5 bps). (Chart 5.) Moreover, there are no expectations of any move away from the current super-ease; nothing on the horizon, as deflation remains a scary bugaboo. Japanese CPI inflation is near 0.5% y/y versus a 2% target.

Steady growth worldwide and steady inflation are translating into advancing equities, and steady interest rates, with low volatility. Yes, interest rates are rising slightly in the short-end where the central bank is tightening (US Fed), but long rates are very steady thanks to a tame inflation outlook and to the thirst for yield. Or else, they are held down by quantitative easing (ECB with 10-year Bunds at 30 bps, BOJ with Japanese 10-year notes at 5 bps). (Chart 5.)

As mentioned above, some of the political events which were expected to rattle things, if only temporarily this year, came and went with little fanfare or addition to volatility. Even Trump’s related scandals, or supposed scandals, have people mired, though some of his political difficulties are bound to delay important parts of his agenda, including tax reform and fixing the currently broken Obamacare system. Both of these very complex endeavors will require time and political capital. It is hoped that running hearings and investigations (Russia, leaks…) and the like, will not further delay things. However, again, it is unlikely we will get anything on that front before yearend. To add insult to injury, by September a budget battle and a debt extension battle will also need to be fought. The US markets are counting on all of this legislation going through without a hitch, even if delayed. The potential for a measure of disappointment is high and should be monitored carefully, given the importance of the US economy and its financial markets to the world economy.

Furthermore, after a long period of expecting three Fed hikes this year, including the two from March and June, the most recent US employment report showed enough weakness to shed doubts on that outlook, and on the Fed’s aggressive expectation of 3 rate hikes in 2018. May employment only added 138K new jobs, and previous revisions put the 3-month average at 121K, the lowest average in five years. (Chart 6.) The drop in the unemployment rate to 4.3% was a bit misleading. It fell because of a fall in the labor force, rather than rising employment. And, wages in the same report posted a very steady 2.4% y/y advance.

Softer employment and steady wages were not surprising enough to derail an expected 25 bps hike by the Fed on 14 June, but enough to raise eyebrows regarding subsequent moves this year and next. This report further pushed the euro higher and the dollar lower, as investors reassess the course ahead for the Fed and as European numbers remain firmer than expected. A tighter ECB, even if after a while, is still not priced in the FX markets. The euro is also benefiting from some political developments, with two elections slated for early June. A UK election (8 June) where PM May seems to be losing her grip, if not the election, has
pressed the GBP. (Chart 7.) While in France President Macron’s new party (REM) performed extremely well in the first round of the June parliamentary election. He is thus slated to have a very comfortable working majority, which shores up the outlook for the EU and the euro.

It is thus still a scenario of “steady as goes the world economy”, with some Fed tightness ahead, decent-to-good smooth Europe, no frills from China and Japan, leading the world economy on an uneventful cruise this year. However, the risks have just gone up slightly on a potentially weaker US or derailed reforms there, as well as on some European shenanigans following perhaps the UK election which has now clouded the Brexit outlook for both partners, now that Mrs. May failed to win outright. Oil is the other factor to watch in the next quarter, especially as it is crucial for the GCC outlook and markets.