Side Effect: Additional hikes are likely to result in Increasing Pain

United States

Dollar Back on Track

During the second half of 2017, only when the political shenanigans stop to be the center of the global scene, it is likely that the world turn their attention to the debate over the Fed balance sheet management as well as the Fed funds rates hikes as well as their implications on the state of the global economy and the US consumers.

Looking only at the state of the US economy, the labor market remains close to full employment. Unemployment rate stands at a 10-year low of 4.4%, inflation remains close to the Fed target and the equity markets in strong shape. Even Fed speakers remain optimistic as Fed president Kaplan stated he still viewed three rate hikes appropriate this year.

So it is definitely likely that during the second half of 2017, a more prominent point of discussion becomes the Fed moving towards a reduction of its sizeable balance sheet and potentially continuing on its path to increase interest rates. Whether a two or three rates hikes, the reduction in the Fed balance sheet accompanied with tighter monetary policy are guaranteed to dramatically slow global growth and cause major malaise in the next twelve months.

Although the French election was a land slide for Emmanuel Macron, it didn’t yield the expected results over the state of the Euro in the short term. This could be explained by the fact that the win gave a sense of market certainty that the Fed would raise rates in June, hence pushing rates differentials again in favor of the US dollar.

On the currency front, the US dollar index started on a strong tone on speculation that the FED will increase interest rates after the latest release of US labor market data. The index appreciated to the highest level since April 21 at 99.88. However the Dollar lost some ground on Friday after inflation readings came below expectation. The index closed the week at 99.189.

Failing to move higher on the back of the French yielding a Pro Europe President, the Euro spent the majority of the week unable to hold its gains against the dollar, falling from a 6 months high of 1.1020. The pair fell indeed to a thirteen days low on Thursday at 1.0838 after US data were unexpectedly better than expected. In Addition, as the ECB explained their reasoning for not altering their monetary policy, the Euro did not get any support throughout the week. It was only until Friday that the disappointing US data led the way higher to close at the 1.0933 level.

Having been the best performing G10 currency until mid-April, the Japanese Yen appreciated by 4.7% against the Dollar between mid-March and April. Since then, it seems that “unconvincingly” tables have turned on the back of the positive US corporate earnings and the interest rate probabilities placing June hike as a certainty for now. The Yen closed the week at 113.33.

In the commodities complex, oil prices rebounded last week after a large drop in U.S crude oil inventories. The Energy Information Administration reported that the stockpiles shrank by 5.2 million barrel last week. Moreover, Saudi Arabia oil minister stated on Monday that oil producers would "do whatever it takes" to rebalance the market and that he expects a global deal on cutting crude output to be extended to the end of 2017 or possibly longer. WTI crude oil ended on Friday at 47.84.

Inflation Supported by Energy Prices

US consumer inflation rose in April, however still missed market expectations for a second successive month. The index rose from a previous reading of -0.3% to 0.2% as energy prices jumped 1.1% in April. On a yearly basis, the CPI increased 2.2%, down from March’s 2.4%. The latest data still remains above the 1.7% average annual increase over the past 10 years. Excluding volatility, core prices increased 0.1% on the month with the year on year rate declining to 1.9% from 2.0% previously.

Producers’ price index rebounded in April by 0.5% from the previous reading of -0.1% amid an increase in food and energy prices. On a yearly basis, the cost of imports jumped 4.1%, supporting producer prices to expand at a rate of

2.5% annually in April. Excluding food and energy volatility, prices surged 2.1% annually from 1.7% in March, suggesting the Fed could reach their inflation target sooner than previously thought.

Robust Labor Market

US job openings unexpectedly edged higher for March as economists predicted a slight decline. The number of job vacancies rose by 61,000 coming at 5.74M. The opportunity for obtaining a job in the US is at the highest level since September 2016 and workers who voluntarily left their jobs remained unchanged at 2.1%, indicating that the labor market continues to tighten. Therefore, the data should support the FOMC to increase the federal funds rate in June.

In the retail sector, sales picked up last month adding further evidence of steady consumer spending. The main sectors that saw stronger demand were auto dealers, hardware stores and e-commerce outlets. Retail sales increased 0.4% versus an expected 0.6%. Higher sales last month might be an indication that delayed tax refunds in 2017 are starting to make their way to citizen's wallets, providing additional support in the months ahead.

Europe & UK

This Time hasn't come yet

"Our monetary policy was successful. Is it time to exit or time to think about exit or not? This time hasn't come yet."

ECB President Mario Draghi defended the banks loose monetary policy this week. The ECB's stimulus program has come under pressure from EU members like the Netherlands and Germany mainly on the back of the negative impact of ultra-low interest rates. Draghi however claimed that the bank was in no rush to tighten its monetary policy despite insistence from these countries.

According to Draghi, the latest data's out of the EU suggest that economic recovery is strengthening and headline inflation is gain upward momentum, but core inflation remains well below the ECB's target. In addition, wage growth remains subdued.

To reiterate this point, ECB Governing Council Philip Lane said that risks in the Eurozone economy are "still below balance but moving towards balance". He also emphasized the "need to see evidence that wage inflation is actually on its way to a level consistent with the target". Regarding future monetary policy path, Lane said that "something has to happen in the rest of this year given there needs to be a plan in 2018."

Positive Momentum in Europe to Continue

The European commission's spring forecast, expects the Eurozone to grow at an annual pace of 1.7% in 2017, up by 0.1% from its prior forecast and an expansion of 1.8% in 2018. In a further sign of a healthier economy, unemployment rate is expected to shrink to 9.4% this year from 10% in 2016, before descending further in 2018 to 8.9%, a bigger drop than previously estimated. The improving conditions forecasted by the commission are largely due to populism losing ground in Europe.

In Germany, growth continues to gain momentum despite the political tension in Europe and around the globe. The economy advanced by 0.6% in the first quarter from 0.4% in Q4 2016. Year on year, GDP rose to 1.7% as exports grew more than imports and higher inflows of investments across most sectors.

Brexit Effects Making British Poorer

The BoE's Monetary Policy Committee voted seven to one on keeping a status quo. On the inflation front, price growth is expected to reach 2.8% this year from an earlier estimates of 2.4%. The bank also expects that average earnings will expand at a rate of 2% this year from the previous estimate of 3%, which is likely to decrease future living standards of citizens in the UK. Carney said "This is going to be a more challenging time for British households."
The bank asserted that it could be the end of 2019 before we finally see a rate rise and increasing rates would not be an effective way of curbing higher living costs.

On the economic front, the trade deficit continues to widen by 5.7 to GBP 10.5 billion. As to the industrial and manufacturing sectors, both have been declining for the past three months consecutively. These sectors are highly

sensitive and positively correlated to consumers demand, which has been subdued recently as rising living costs and relatively dull wage growth take its toll on consumers.
In details, industrial output dropped by 0.5% compared with February's 0.8% fall. Manufacturing fell 0.6% in March and 0.1% previously. As a result, the economy only expanded 0.3% in the first quarter of this year and is expected to remain subdued for the remaining of the year.

Asia

Assessing the Impact of Policy Tightening

Bank of Japan Governor Kuroda said that the central bank will consider reporting calculations on how a future monetary tightening possibility could affect its balance sheet financial health despite not currently thinking about any specific amendments to the BoJ's monetary policy. The Governor claimed that economic recovery is firmer, but uncertainty over US economic policies remained the biggest risk to its outlook.

Mixed Signals from the Australian Economy

The monthly business confidence survey released by the National Australian Bank for the month of April indicated that business confidence surged to 7 years high. The confidence index jumped by 7 points to 13. Any figure above zero suggests improving conditions. The rise in the index is mainly attributed to ongoing improvement in employment conditions.

On the other hand, the latest retail sales data showed sales falling by 0.1% month to month in March. Investors remain skeptical about the sector after data dropped three out of the four months and growth in the retail sector has decelerated to the slowest in almost four years.

The weak data point to low consumer confidence, international competition and housing affordability. However, the Reserve Bank of Australia forecasted last week a steady growth for the domestic economy in 2017 with GDP growth and annual inflation rising.

Weak Domestic Demand in China

Exports and imports data came in short of expectations for the month of April. In Yuan terms, exports rose 14.3% year to year versus a forecast of 16.8%, while imports rose 18.6% as markets expected a 29.3% jump. The latest data pushed the countries trade surplus to the highest since January, coming in at yuan 262.3 billion. Needless to say that further policy tightening may pressure domestic demand in the months ahead. On the other hand, markets anticipate that growth will hold well given the relatively bright outlook for the global economy this year.

Looking at inflation, China's inflation rose more than expected in April. The CPI index increased by 0.3%, coming at 1.2% for the year. The rise in headline inflation is elevated due to a rise in non-food prices growing 2.4% from last year and higher producer costs from the previous quarter has started to shift into higher prices for consumers.

On the producer front, inflation cooled down for the month of April after fears of weak domestic demand in China lowered commodity prices. The PPI index rose below expectations coming at 6.4% and easing further from the previous month's gain of 7.6%. The recovery that emerged last year in the economy is mainly attributed to higher commodity prices and with market interest rates at a tighter mode, economic expansion may moderate in the coming quarters.

Kuwait

Kuwaiti Dinar at 0.30445

The USDKWD opened at 0.30445 on Sunday morning.

Rates – 14th May, 2017

	Previous Week Levels				This Week's Expected Range		3-Month
Currencies	Open	Low	High	Close	Minimum	Maximum	Forward
EUR	1.0996	1.0838	1.1022	1.0927	1.0740	1.1180	1.0985
GBP	1.2979	1.2842	1.2987	1.2883	1.2790	1.3085	1.2930
JPY	112.97	112.37	114.36	113.33	112.40	115.15	112.85
CHF	0.9887	0.9863	1.0099	1.0005	0.9935	1.0215	0.9950