The Fed and the GCC countries raise rates 25 bps; Kuwait issues USD 8 billion in 5 and 10-year bonds

Summary

It’s over. The fully priced and fully anticipated rate hike by the Fed took place last week. The federal funds rate target was raised from 50-75 bps to 75-100 bps. Concerns that the Fed would move toward a more hawkish stance, compared to before its meeting, were allayed by Fed Chair Janet Yellen and by the latest FOMC dot-plots. The dot-plots, which previously showed Fed members expecting 3 rate hikes in 2017, moved up a bit, but the majority is still anchored around 3 moves for this year.

The announcement led the US equity markets to rally (strong economy and gradual Fed), while the USD and interest rates both fell a tad on the notion of further gradualism from the Fed.

The Dutch election results were also a factor behind the firmer Euro this week. The anti-EU/anti-immigration party of Mr. Wilders did gain seats but came in second and failed to gather much new momentum. The results thus suggest that the potential for such parties elsewhere in the EU to make strong gains could be overestimated, notably one month before the closely watched French presidential election.

With their currencies pegged or linked to the USD, all the GCC countries except Oman followed the Fed’s rate hike with hikes of their own.

GCC bond issuance continues to dominate the financial news in the GCC. Kuwait issued a very successful USD 8 billion international bond that was priced at 75 bps and 100 bps over Treasuries for 5 and 10-year bonds, respectively, the tightest spreads in the region (see below).

International macroeconomics

USA: February CPI was up 2.8% y/y, the highest since 2012. However, the more reliable core CPI was up 2.2%, pretty much the steady pace of that measure for over 12 months now. Also, retail sales rose a weak 0.1% m/m in February, but a revision put the January rise at a solid 0.6% m/m. These data are in line with the Fed’s current expectations and targets, which are about 2.0% for both GDP growth and PCE-deflator inflation in 2017 and 2018.

There is little reason for the Fed to change its current stance of gradualism: 3 hikes this year, and postponing any potential asset sales until the federal funds rate is closer to “normal”. The latter could be two rate hikes away. As mentioned above, the latest dot-plots showed the Fed still anchored at 3 rate hikes for this year (and the same for next year).

Politically, Congress and the White House are still struggling to pass complex legislation on reforming Obamacare and the tax code as well as a new budget. It should be no surprise that all these will be contentious and likely to take time. Tax reform should not happen before Q4 in the best of cases.

Eurozone: The outcome of the Dutch elections brought a sigh of relief for pro-Euro pundits and investors who feared a win by the far-right. Prime Minister’s Rutte’s center-right VVD party won with 21% of the vote. Nonetheless, the real victory was in the poor performance of Wilder’s far-
right PVV party, which collected only 13% of the vote despite a large lead in the polls months earlier.

**UK:** Unemployment dropped to its lowest rate, 4.7%, since 2005. (Chart 1.) Employment continued to hold steady at its highest rate of 74.6%. However, while the figures undoubtedly point to a resilient UK economy amid all the Brexit-related uncertainty, average annual wage growth slowed from 2.6% to 2.3% in the three months to January. And with inflation rising, real wage growth has slowed to its lowest level since 2014 (0.8% y/y).

The Bank of England (BoE) kept interest rates unchanged at 0.25% last Thursday, citing concerns over softening wage growth and weaker estimates of retail sales. The decision was not unanimous, however, with one of the nine members of the committee voting to raise rates.

The two Article 50 amendments proposed by the House of Lords which aimed to safeguard the rights of EU citizens resident in the UK and give parliament the right to force the government to renegotiate a better deal with the EU were rejected by the Commons last week. And with the Lord’s unwilling to debate the amendments again, the Article 50 exit document thus became law. PM Theresa May was due to officially inform the EU last week but was forced to delay when Scotland’s First Minister, Nicola Sturgeon, indicated that she intends to seek another referendum on Scottish independence as early as next year. The move has angered Westminster and pushed Sterling down 0.5% against the US dollar on the day to 1.217—just off its record low of 1.215.

**China:** In its usual mid-month fashion, the Chinese government released a slew of data. Retail sales growth slowed to 9.5% y/y for the sum of January and February 2017, compared to the corresponding period in 2016. Fixed asset investment picked up to 8.9% y/y in the Jan/Feb period, supported by increased government spending. Industrial production growth picked up slightly to 6.3% y/y for the Jan/Feb period in 2017. (Chart 2.) Though domestic demand seems to be cooling in light of retail sales, China cannot use its monetary policy to spur domestic demand when the risk of capital flight is still high. The People’s Bank of China opted to tighten conditions, using repo rates rather than the traditional reserve ratio rate and other policy measures. On 16 March, China raised the one, two, and three-week reverse repos by 10 bps to 2.45%, 2.30%, and 2.75%, respectively.

**Japan:** As was widely anticipated, the Bank of Japan (BOJ) stood pat on its monetary policy during its monthly meeting last Thursday, even as the Fed raised rates. It maintained its positive outlook on the economy and signalled that it was unlikely to expand its monetary stimulus program any time in the near future. The yen was marginally stronger against the USD amid all the Brexit related uncertainty, average annual wage growth slowed from 2.6% to 2.3% in the three months to January. And with inflation rising, real wage growth has slowed to its lowest level since 2014 (0.8% y/y).

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**GCC & regional macroeconomics**

**Kuwait:** Kuwait issued its first international bond, raising $8 billion (KD 2.44 billion) at a pricing superior to other GCC sovereigns. Two tranches were offered, with $3.5 billion in a 5-year at 75 bps over equivalent US Treasuries (2.88%) and $4.5 billion in a 10-year at 100 bps over Treasuries (3.62%). The spread was below Abu Dhabi’s, which until now had been considered the “gold standard” in the GCC. In the secondary market, yields on the new bonds tightened slightly.
The MOF also issued KD 100 million in 3-year domestic bonds, increasing domestic debt to KD 3.9 billion. The MOF increased debt by KD 4.7 billion during FY16/17, increasing total government debt to KD 6.3 billion or an estimated 18% of GDP.

The Central Bank of Kuwait hiked the discount rate, its key policy rate, by 25 bps to 2.75%, effective 16 March, following a similar move by the Fed. The hike maintains the spread to the US federal funds rate target at 1.75%, in line with the historic level, and helps stave off potential outflows.

Credit growth was steady in January, though the month saw a small decline in outstanding loans. Growth came in at 3.1% y/y. A monthly decline of KD 73 million was registered, largely due to drops in lending for the purchase of securities and credit to investment companies. In contrast, household lending and business credit did well. (Chart 3.)

Employment growth among Kuwaitis slowed through December 2016 to 1.9% y/y from 3.1% y/y a year ago. The slowdown has come from private jobs, where a clampdown on “phantom employment” has resulted in a contraction in the last 18 months. Growth of nationals in the public sector has remained largely steady at 3.5% y/y. Expatriate employment maintained healthy growth of 5.6%, with the strongest growth in unskilled employment.

The Ara consumer confidence index slipped to 96 points in February, down 8% y/y. The index has been below the 100 point mark since August 2016 when the government announced plans to increase fuel prices. (Chart 4.)

The trade surplus fell to an 11-year low of KD 4.7 billion in 2016 or 14% of GDP, as oil export earnings remained weak against a backdrop of limited import growth. (Chart 5.) Oil export revenues were hurt by lower oil prices, though we expect them to pick up in 2017. Imports were flat in 2016, consumer goods contracted while capital goods remained healthy.

Saudi Arabia: Following the US Federal Reserve’s 25 bps rate increase, SAMA raised its key reverse repo rate by 25 bps to 1.0%. Mirroring the Fed’s move each time, this is the kingdom’s third 25 bps rate hike since December 2015. The repo rate was left unchanged at 2.0%. (Chart 6.)

Headline inflation in Qatar eased to its lowest level in more than five years, at 0.7% y/y, in February 2017. (Chart 7.) Prices in the recreation, culture, restaurant and hotel sectors as well as in housing (rents) and utilities all contracted in y/y terms, contributing to the overall slowdown in headline inflation. Transport prices continue to pick up (5.9% y/y) on the back of government-driven fuel price hikes. The government has moved to equalize domestic energy prices with international prices in order to reduce subsidies and ultimately contain spending.

Oman: Oman registered its highest increase in consumer prices in over 5 years in February when the CPI came in at 2.4% y/y. The increase was driven by the hikes in fuel prices.

Egypt: Saudi Arabia will resume oil shipments to Egypt about six months after they were suspended following political disagreement. The shipments of oil on terms favorable to Egypt, agreed to in April 2016, were
intended to boost Egypt’s ailing economy and provide a show of support to President Sisi. The move is positive and could help reduce Egypt’s fiscal and external deficits.

Markets – oil

After flirting with a 3.5-month low, when it dropped to $50.92/bbl last Tuesday, Brent crude rallied almost 1.7% to close the week at $51.76/bbl after markets digested the news that US crude inventories had decreased for the first time this year. (Chart 8.) The 237,000 b/d fall in US crude stocks was unexpected; consensus expectations had been for a tenth consecutive rise in inventories, of around 3.2 million barrels.

The positive data out of the US helped push prices up marginally after being pressured in the wake of Saudi Arabia’s official admission that it had increased production in February (but still within its OPEC quota), and amid broader concerns that OPEC/non-OPEC cuts would not be enough to erase the supply glut in the face of seemingly relentless output gains by US shale. The admission of a production increase by the Saudis against a backdrop of falling prices (prices were down almost 10% in a week) forced the energy ministry to issue a rare statement to affirm the kingdom’s continued commitment to the OPEC production cut agreement and to “stabilizing the global oil market”.

Markets – equities

Equities registered some gains this week with the MSCI World advancing 0.5%. The week was generally quiet ahead of the anticipated Fed hike, and most markets rallied following the Fed’s move. However, US equities subsequently retreated, with the S&P 500 and DJIA up just 0.2% and 0.1%, respectively, on the week. European equities gained, with the Euro Stoxx 50 up 0.9%. Meanwhile, emerging markets outperformed, with the MSCI EM up 2.9% on the week as riskier assets benefited from a continued flow of positive data from major economies. (Chart 9.)

Falling oil prices weighed on regional markets which underperformed. The MSCI GCC index closed the week down 0.3% despite the gains made in the last trading session of the week following the Fed hike. With the exception of Oman, all regional central banks raised rates in tandem with the US. (Chart 10.)

Qatar saw the second tranche of its upgrade to FTSE’s emerging market index, with up to a $1 billion in new inflows expected as a result. The move completes FTSE’s upgrade, which was introduced with a partial weighting in September. The market is down 0.7% year-to-date (ytd) and is unlikely to see a rebound following the upgrade absent a catalyst.

Markets – fixed income

Bond markets were quiet for most of the week in anticipation of a handful of large events. Except for some safe haven buying on the eve of the Dutch election that pulled some European rates lower (10-year bunds reached close to 0.4%); yields for most global benchmarks maintained their previous week highs. They dipped later in the week following a relatively dovish outlook from the Fed. Markets are now expecting the Fed’s next two moves to occur mid-year and at year-end. With less future pressure on US rates in the short term and inflation expectations unchanged, yields on 10-year US Treasuries finished the week down 7 bps. (Chart 11.)

The win by incumbent Dutch PM Rutte also helped calm markets, relieving...
some pressure off riskier European government bonds. This also saw investors unwind some of their safe haven positions in bunds, with 10-year bunds ending the week at 0.43%, but still 5 bps lower from where they started.

The Bank of England and the Bank of Japan both left their monetary policies unchanged, with the former delivering a more hawkish view. As for Japan, its efforts to keep rates low through its yield curve control mechanism may be increasingly challenged in a global environment of rising rates.

GCC yields on paper maturing in 2021 tracked US Treasuries lower. Yields dropped across most sovereign paper between 4 bps and 11 bps, though Abu Dhabi’s 2021 yield was steady. Kuwait’s freshly-issued 2022 bond tightened to 2.81% compared to 2.88% at issuance on 14 March 2017. (Chart 12.)

All GCC central banks, with the exception of Oman, raised their policy rates by 25 bps in line with the Fed rate hike.
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