International scene

Market volatility off, as outlook and rate expectations steady

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After a horrid start to the year, equity markets recovered some ground in March, to levels that left them "flat" or down slightly on the year. Besides technical factors, the markets' recovery was driven by more encouraging US data, further QE efforts by the ECB (European Central Bank), dovish signs by the Fed, as well as recovering oil markets. Two primary sources of uncertainty and volatility, which lingered from last year, were thus somewhat removed. First, the Fed, which was signaling (not so credibly) four 25-basis point (bp) hikes for 2016, finally toned down its rhetoric. It is now looking for two hikes. And second, oil prices that seemed to have no floor underneath them back in January finally appeared to bottom in the mid-20s and are currently trading near the $40 pb level (on a Brent basis). Further market help came from the ECB and the BOJ. Both central banks eased further with more QE action and/or lower (negative) interest rates, on top of other measures.

To a large extent, the "perfect storm" (weak US growth, lower oil prices, stronger US dollar) that had hit markets in mid-2015 and again in January 2016 faded in light of better economic news and of a more soothing stance by the Fed. We seem to be back to a benign, though unimpressive, global environment. Other sources of concerns that had pressured markets, namely fears of a US recession and a Chinese hard landing, were also assuaged and allowed the markets, and oil prices, to regain some footing in March. China appeared to grow a little under 7% in 2015. Moreover, yes, China is slowing, and yes, the growth rate is very likely well below official numbers, but the slowdown appears contained and confidence in the Chinese authorities' ability to reboot the system, if needed, remains solid among investors.

As for the US, GDP growth is currently close to the 2% mark year-on-year (y/y), the average growth pace since the recovery of 2010. The first quarter appears to have been flat for GDP, which will comfort those looking for a dovish Fed. Employment continues to be in line with the Fed's view. Namely that labor slack is tightening, wages are firming slightly (over 2% for 7 months), and employment gains are reasonably robust (monthly gains over 200K). March nonfarm payrolls saw a gain of 215K and unemployment stayed near 5.0%. The labor data allows the Fed to hang on to its relative hawkishness for a while, and still support or justify the need for further normalization. We think that two 25-bp hikes are reasonable this year, around mid-year and year-end.

We do note, however, that non-US inflation remains weaker and that the Fed's favorite inflation measure, the PCE deflator, is in check and below target. The more alarming data that had raised recession fears such as weak or weakening PMI data (manufacturing and non-manufacturing) have since firmed up. European growth data was also "cooperative" as Europe had its best growth year since 2010, at 1.8% for GDP.

Nevertheless, the inflation data (especially non-US) and lower oil

prices are keeping the pressure on all central banks to stay in super-easy mode or for the Fed to remain slow and cautious when tightening or "normalizing" further. The ECB went deeper into QE territory in March by increasing the size of its monthly purchases of securities from EUR 60 billion to 80 billion per month, and by cutting some rates even deeper into negative territory. Earlier in January, the BOJ had gone into negative rates territory for the first time. It was a surprising preemptive move by the BOJ, the most deflation-sensitive central bank. All of these moves kept international interest rates low, and are preventing US rates from rising, if at all. The US spreads to European and Japanese bonds remain very attractive (well over 100 bps). These spreads failed to help the USD in Q1, though we also note that headline US inflation is higher than that of its peers. US CPI inflation was 1.0% in February, versus -0.2% for the Eurozone. In other words, the "real" interest rate spreads are not as favorable to the USD.

With the return to more reasonable Fed expectations, short-term US interest rates are down from the week the Fed moved to raise rates back in December 2015. The 2-year rate is down 20 bps at 72 bps while the 10-year rate is down 45 bps since that time, to about 1.75%. In the same period, the USD, contrary to conventional wisdom, fell against the euro and the yen (3-5%) while the GBP lost some 4% on dovish BOE news and uncertainty surrounding Brexit (June 23 referendum). The decline of the dollar versus the euro is important, as it is a major factor allowing the Fed to pursue normalization, if needed, without undue dollar strength.

Analysts and markets are back to expecting an "OK" 2016 for economies, in line with the last two years when world growth averaged 3.2%. In its revised outlook, the IMF is looking for world GDP growth of 3.2%. The outlook was revised 0.2% lower, and most countries saw a downward revision with the notable exception of China. For the large economies, the US is expected to grow 2.4%, the euro area 1.5%, Japan 0.5%, China 6.5% and EMs at 4.1%. In our view, the US and emerging markets are more prone to downward revisions. We thus expect the Fed to be targeting a fed funds rate of 75-100 bps in December 2016 (in 2 rate hikes).

The somewhat recovering commodity prices seemed to help the outlook for some commodity economies, though Brazil is still mired in recession and political problems. Markets, spreads, and CDS rates have recovered somewhat as well in the GCC countries, thanks to recovering oil prices in March.

For the GCC economies, we expect moderate GDP growth in 2016, as governments remain committed in large part to government spending, notwithstanding adjustments and cuts already implemented or upcoming. The adjustments should be gradual, as policy makers are keen on keeping growth smooth and ongoing. Non-oil GDP growth should post 4-4.5% for the region. All GCC countries are gearing up to issue sovereign debt in order to finance their deficits. Debt issuance is pressuring liquidity but is also creating an opportunity for the region to further open up and develop its fixed-income markets.

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