Weekly Economic and Markets Review

NBK Economic Research Department I 1 July 2018

International & MENA

Rise in US inflation provides support for rate hike prospects; Brent crude rallies close to $80

Key market indicators

Stock markets	Index	Change (%) weekly	YTD
Regional			
Abu Dhabi (ADI)	4,560	0.55	3.67
Bahrain (ASI)	1,311	0.12	-1.56
Dubai (DFMGI)	2,821	-3.66	-16.29
Egypt (EGX 30)	16,349	0.02	8.85
GCC (S&P GCC 40)	1,011	0.55	2.72
Kuwait (All Share Index)	4,890	1.40	1.24
KSA (TASI)	8,314	1.31	15.05
Oman (MSM 30)	4,572	-0.83	-10.35
Qatar (QE Index)	9,024	1.14	5.87
International			
CSI 300	3,511	-2.71	-12.90
DAX	12,306	-2.18	-4.73
DJIA	24,271	-1.26	-1.81
Euro Stoxx 50	3,396	-1.34	-3.09
FTSE 100	7,637	-0.59	-0.66
Nikkei 225	22,305	-0.94	-2.02
S&P 500	2,718	-1.33	1.67

Bond yields	%	Change (bps) weekly	YTD
Regional			
Abu Dhabi 2022	3.59	-0.9	64.5
Dubai 2022	3.99	0.8	84.8
Qatar 2022	3.79	-1.9	71.5
Kuwait 2022	3.48	-5.9	67.5
Saudi Arabia 2023	3.77	-6.9	55.5
International			
UST 10 Year	2.85	-4.9	44.0
Bunds 10 Year	0.31	-2.5	-11.6
Gilts 10 Year	1.28	-4.1	9.1
JGB 10 Year	0.03	-0.1	-1.9

3m interbank rates	%	Change (bps) weekly	YTD
Bhibor	3.50	0.0	77.5
Kibor	2.00	0.0	12.5
Qibor	2.64	3.1	-10.1
Eibor	2.43	-4.9	63.2
Saibor	2.59	5.3	69.6
Libor	2.34	0.2	64.3

Exchange rates	Rate	Change (%) weekly	YTD
KWD per USD	0.302	0.08	0.39
KWD per EUR	0.352	-0.20	-0.87
USD per EUR	1.168	0.24	-2.61
JPY per USD	110.7	0.64	-1.78
USD per GBP	1.321	-0.46	-2.26
EGP per USD	17.84	0.11	0.62

Commodities	$/unit	Change (%) weekly	YTD
Brent crude	79.4	5.15	18.80
KEC	76.4	5.82	20.31
WTI	74.2	8.12	22.72
Gold	1251.3	-1.27	-4.21

Source: Thomson Reuters Datastream; as of Friday's close 29/6/2018

Overview

Global markets saw another down week with key equity indices falling 1-2% as President Trump said he would consider restrictions on Chinese investments in the US, ratcheting up trade tensions. The move was reportedly shelved following the negative market reaction. Meanwhile, data in both the US and Eurozone showed inflation on different measures hitting the 2% mark, leaving it either at or above central bank targets. In the US in particular, this was seen as supporting the case for higher interest rates and a stronger dollar, which ended the quarter on a high rising 5% on a trade-weighted basis in 2Q18.

Despite OPEC's earlier announcement that it would lift output by up to 1 million b/d from July to ease pressures in a tightening market, oil prices pushed higher last week with Brent crude finishing a touch short of $80/bbl at $79.4, up a hefty 5% w/w. One factor was the US's more-forceful-than-expected stance on limiting Iranian oil exports by refusing to grant sanctions waivers to key importers in Asia. This in turn fueled concerns over the lack of spare global production capacity and the inability of key suppliers including Saudi Arabia and Russia to compensate for potential output falls in Iran, Venezuela and Libya.

Governments in Saudi Arabia, Kuwait and the UAE committed to providing fresh assistance to Bahrain to help ease financial strains that had caused a spike in government bond yields and currency market pressures. Concerns had intensified over previous days on a perceived lack of progress on reducing the government's large fiscal deficit expected at 9% of GDP this year, rising debt levels, dwindling reserves and an upcoming $750 million sukuk payment due in November. Details of the package have yet to be announced but are expected to be conditional on deeper reforms with Bahrain's gulf neighbors keen to stave off a crisis that could spark contagion.

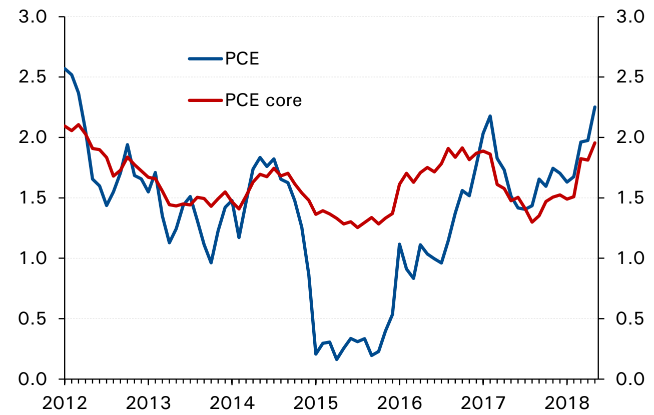
International macroeconomics

USA: News on the consumer sector was less bullish than of late, with consumer spending rising by a less-than-expected 0.2% m/m in May after a 0.5% increase in April. Surveys were also softer, with the Conference Board's gauge of consumer confidence edging down in June perhaps affected by recent news on tariffs, though the index remains at historically strong levels; and the outlook component of the University of Michigan survey also dipped, likely for similar reasons, despite a still-firm headline. The Case-Shiller index showed house prices edging up by their smallest amount since June 2017 at 0.3% m/m in April, a further hint of a moderation in recent housing market strength.

However the closely-watched core personal consumer expenditure inflation measure rose by more than expected to 2.0% y/y in May from 1.8% in April, the first time it has hit the Federal Reserve's targeted 2% rate in six years. (Chart 1.) The Fed's recent statements suggest that it is prepared to let inflation run above target for a time but a combination of strong growth, capacity constraints and price hikes due to tariffs could see rates increased by a further 50 bps this year. Core capital goods orders meanwhile, eased back only 0.2% m/m in May after a 2.3% surge in April, still pointing to a factory sector in strong shape.

Chart 1: US PCE inflation

(% y/y)



Source: Thomson Reuters Datastream

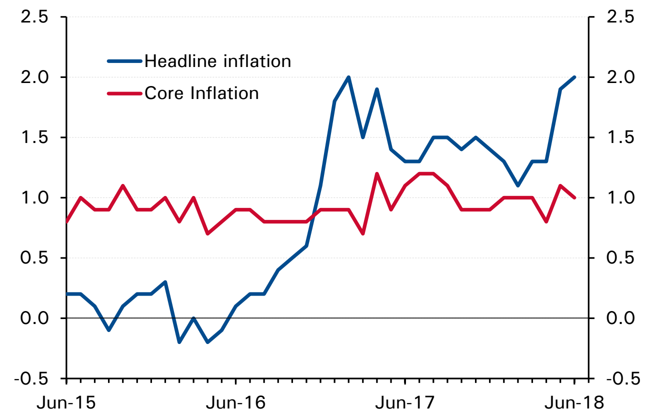
Eurozone: An EU deal on migration helped alleviate concerns over a hot-button issue that catalyzed the rise of anti-establishment parties across Europe and consistently threatened Germany's nascent and still-fragile coalition. Although the deal did not offer a comprehensive framework, it did provide initial steps to a solution, overall helping ease political tensions.

European data was somewhat encouraging last week, with headline inflation rising to 2.0% in June (chart 2) lifted by energy prices, and economic sentiment easing to a less-than-expected 112.3 during that same month.

However, underlying dynamics remain soft. Core inflation edged lower to 1.0% y/y from 1.1% in May, while both consumer and business confidence – sub-components of the economic sentiment index – eased, the latter impacted by the escalating global trade war.

Chart 2: Eurozone inflation

(% y/y)



Source: Thomson Reuters Datastream

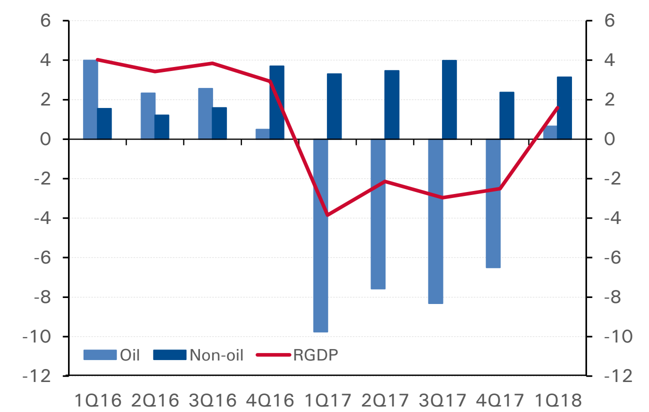
Meanwhile, Eurozone May retail sales, out this week, are expected to have been little changed m/m, according to a Reuters poll, potentially causing the y/y rate to ease to 1.4% from 1.7% in April and providing further affirmation to the moderation in 2Q18 growth.

GCC & regional macroeconomics

Kuwait: GDP expanded by a healthy 1.6% y/y in 1Q18, supported by a slight rise in oil GDP (+0.7% y/y) and a firmer non-oil sector (+3.1% y/y). (Chart 3.) Manufacturing and telecoms drove growth in the non-oil economy, and were accompanied by steady and decent growth in the wholesale and retail trade sector, potentially reflecting improvement in the consumer sector. As such, our expectations remain unchanged: overall growth is projected at 2.5% in 2018, with non-oil at 3.5% and oil at 1.5%.

Chart 3: Kuwait GDP

(% y/y, quarterly)



Source: Central Statistical Bureau

Bahrain: Saudi Arabia, Kuwait and the UAE were reportedly close to announcing a joint program to support Bahrain's economic reforms, stabilize its finances and reassure anxious financial markets after a massive sell-off last week. The sell-off was sparked by renewed concerns that the kingdom would not be able to tap international markets indefinitely in order to finance its large fiscal deficits. Bahrain will need around $10 billion over the next two years for debt-servicing and repayment alone, 60% of which is due by the end of this year.

Bahrain's main credit default swaps on five-year government debt climbed to 581 basis points last Tuesday, the highest level in almost 10 years. (Chart 4.) The spread between Bahrain's US dollar conventional bonds and its Islamic bonds also swelled to record levels. This suggests that there is disagreement between global and regional investors about the extent to which Bahrain can continue to finance its deficits.

Chart 4: Bahrain 5-year credit default swap

(basis points)

Source: Thomson Reuters Datastream

The sell-off in the bond market (Chart 5) had negative repercussions on the foreign exchange market: Bahrain's dinar fell to a low of 0.38553 against the US dollar in the one-year forward market, which is around 2.5% below the official pegged rate of 0.37608. (Chart 6.)

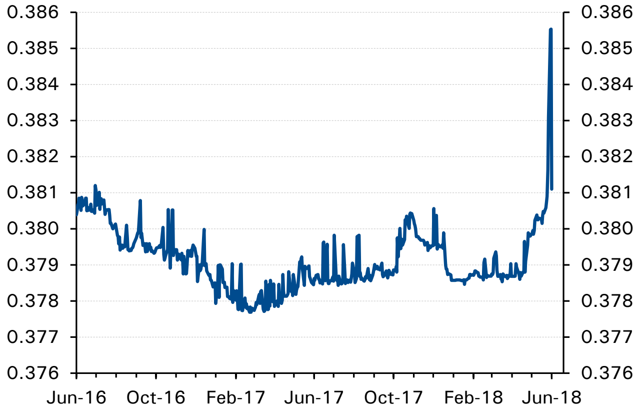
Chart 5: Bahrain 5-year government bond yield

(%)

Source: Thomson Reuters Datastream

Chart 6: Bahrain 12m forward FX rate

(BHD per US$)



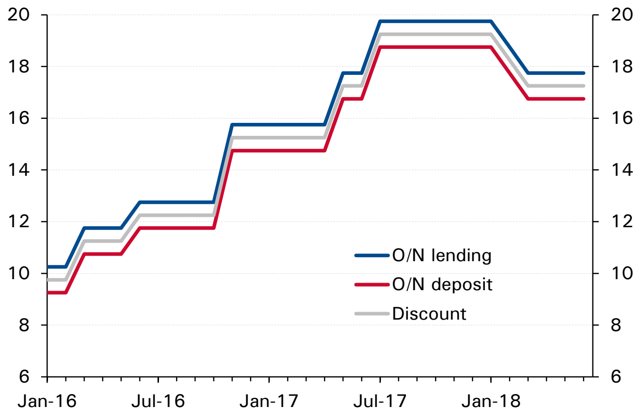
Source: Thomson Reuters Datastream

In response, the central bank issued a statement reiterating its commitment to maintaining the fixed exchange rate – a key plank of economic and financial stability. Together with the promise of fresh GCC aid, this helped to moderate some of the pressure in bond and currency markets.

Egypt: The central bank left interest rates unchanged, with the overnight deposit and lending rates at 16.75% and 17.75%, respectively. (Chart 7.) The bank has cut rates twice by a cumulative 200 bps so far this year on falling inflation and a more stable currency. This time, however, it cited a likely temporary rise in inflation over coming months from its current 11.5% due to the latest rises in fuel and electricity prices as a reason to hold off from a fresh cut. The bank is expected to resume its rate cutting cycle later this year.

Chart 7: Egypt policy interest rates

(%)



Source: Thomson Reuters Datastream

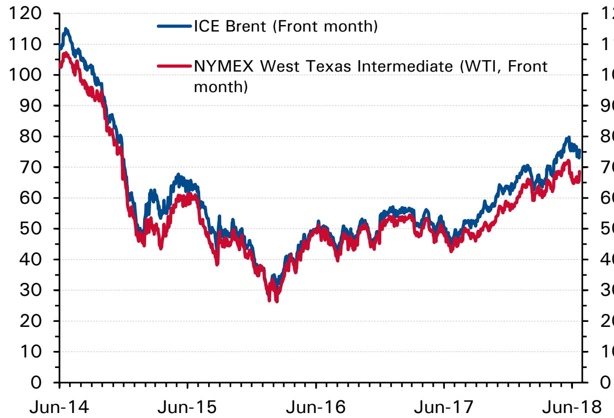
Turkey: Recep Tayyip Erdogan declared a double victory after surpassing the 50% threshold required to claim the presidency, with 52.6% of the votes, and after the alliance led by his ruling Justice and Development Party (AKP) also claimed a majority in parliament. Following the victory, President Erdogan will run a second five-year term, but this time with major new powers narrowly approved in a referendum last year. The economic impact of this election will depend on whether Mr. Erdogan will be able to re-assure foreign investors – who provide the financing on which Turkey heavily depends – of his intentions regarding economic policy and more specifically to grant complete independence to the central bank in conducting its monetary policy.

Markets – oil

Oil prices were back up near to four-year highs last week. Brent and WTI posted four consecutive up days to finish at $79.4/bbl (+5% w/w; +19% ytd) and $74.2/bbl (+8% w/w; +22% ytd), respectively, shrugging off the prospect of OPEC pumping an additional 1 mb/d over the next six months. (Chart 8.)

Chart 8: Crude oil prices

($/bbl)



Source: Thomson Reuters Datastream

Instead, price gains have been motivated primarily by fears of a significant drop in global supplies amid historically thin spare production capacity. Chief among the supply worries is the loss of Iranian barrels once US sanctions kick-in. Last week the Trump administration indicated that it would pursue a zero tolerance policy towards importers of Iranian crude (with respect to sanctions waivers), raising the possibility that far more Iranian crude would be withdrawn from the market than was the case in 2012. India instructed its refiners to prepare for a "drastic reduction or zero" Iranian oil imports from November. President Trump contacted the Saudi king over the weekend to ask him to boost output by 2 mb/d to compensate for soon-to-be embargoed Iranian barrels and soothe prices. It is not clear if Saudi Arabia will boost its production to this level, but if does, its oil production will rise to an all-time high. At the same time, the available Saudi (and global) spare production capacity would all but disappear.

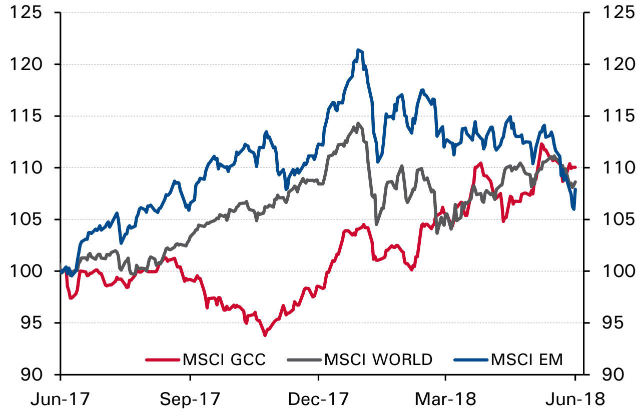
Continuing production declines in Venezuela and recently in Libya round out a week of increasing supply worries, while over in the US, a greater-than-expected crude stock draw of 9.9 mb for the w/e 22 June is supporting the view that oil demand continues to be robust.

Markets – equities

Escalating trade war rhetoric further soured global investor sentiment last week, with the MSCI AC World index down 1.2% w/w. EM stocks also fell 1.2% w/w according to MSCI's EM index, driven by a 2.7% decline in the Shanghai Shenzhen CSI 300 Index. In the US and Europe, encouraging data, and positive Fed stress tests for American banks, helped cut back losses in major indices, with the S&P, DJI, and Euro Stoxx 50 each down 1.3% w/w. (Chart 9.)

Chart 9: Total equity return indices

(rebased, 29 June 2017=100)



Source: Thomson Reuters Datastream

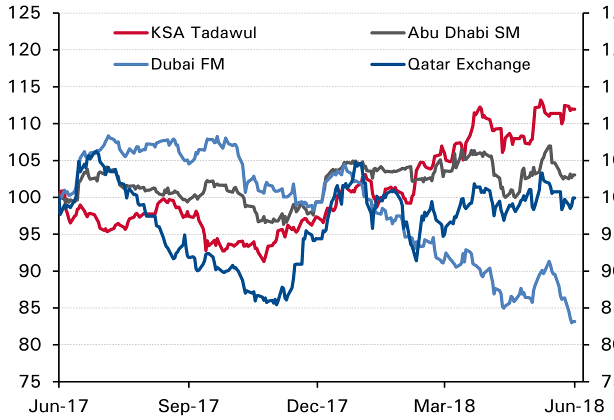
Over the quarter, despite looming fears of a global trade war, talk of (and actual) tightening central bank policies, as well as political uncertainty in Europe, international markets outperformed relative to the previous quarter: the MSCI AC index increased by 2.0 in 2Q18, compared to a decline of 2.3% in 1Q18.

The MSCI GCC index was up 0.9% w/w, with most regional markets continuing to benefit from investor confidence boosted by the MSCI news and improving oil prices, except for Dubai. (Chart 10.) The DFM index retreated 3.7% w/w, and 8.9% over the last thirteen trading days, following concerns over Abraaj's liquidation and a sell-off in real estate stocks. Meanwhile, Kuwait was the best performer, climbing 1.4% w/w, with market activity re-invigorated by its inclusion in MSCI's watch list. Indeed, trading volumes have averaged KD 18 million per day since the announcement (20 June), well above its year-to-date average of KD 11 million per day.

Saudi and Qatar, however, outdid their peers in 2Q18, increasing by 5.6% q/q and 5.2% q/q, while Dubai was the worst performer, down 9.2% q/q.

Chart 10: GCC equity markets

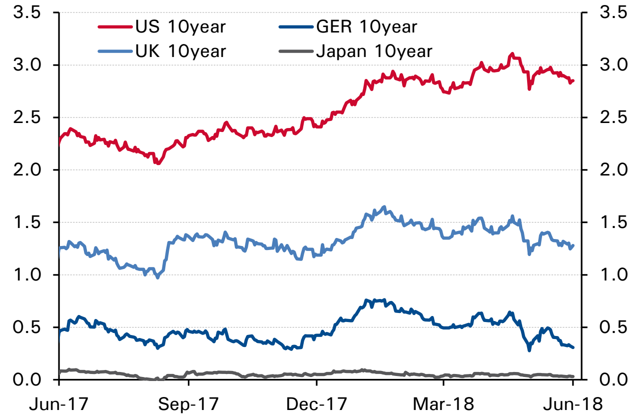
(rebased, 29 June 2017=100)



Source: Thomson Reuters Datastream

Chart 11: Global bond yields

(%)



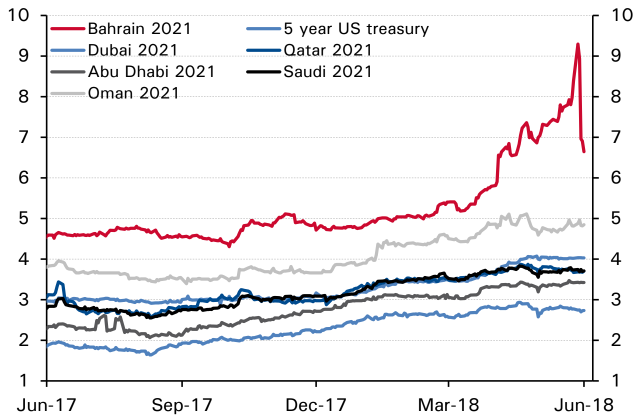
Source: Thomson Reuters Datastream

Markets – fixed income

Trade wars, China growth fears, and political uncertainty over the consequences of the EU migration summit pressured yields lower, despite some encouraging data late in the week. US 10-year yields were down 4 bps to 2.85%, while 10-year bund yields shed 3 bps to settle at 0.31%. (Chart 11.) In the GCC, yields on Bahraini debt eased back to normal levels following a pledge by Saudi Arabia, the UAE, and Kuwait to financially support the small kingdom, helping ease shot-term refinancing concerns. (Chart 12.)

Chart 12: GCC bond yields

(%)



Source: Thomson Reuters Datastream

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