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Weekly Money Market Report

1 July 2018

The Divergence in Economic Fundamentals

United States

Stronger Dollar, a Nightmare for Emerging Markets

A robust US dollar, tightening monetary policy and broadening geopolitical dangers have molded the winners and losers in the financial and equity markets. As the second quarter comes to an end, the tech sector, small US companies and oil prices have come up on top since the start of the year. The rise in the above classes came at the cost of negative performances in euro-zone periphery sovereign debt, EM currencies and equities and Chinese shares have all performed poorly. Looking at American Bank equities, shares are lower by 10% from the peak in January as the Treasury yield curve has relentlessly flattened.

Lately, a more significant issue has risen for markets and one that will fundamentally determine the performance of classes in the coming months is the path of Federal Reserve policy and further elevation in the US dollar. A stronger US dollar increases the probability of further weaknesses in Emerging Markets. The US economy continues to outperform its peers and other developing nations, which is causing a deviation in interest rates and economic figures. If economic fundamentals continue to widen, then a further correction in emerging markets may occur. Many developed countries are exposed to those markets in terms of investments and loans.

The US Federal Reserve Achieves its Inflation Goal

The FED's preferred measure of inflation rose to the central bank's target of 2% and the headline PCE followed the same trend towards 2.3%. Both figures are at the highest levels since 2012. The latest figures are inspiring for the Fed, although inflation expectations have remained somewhat subdued in regards to the US unemployment rate. A concern recently expressed by Fed Chairman Jerome Powell. Policy setters stated they expect to keep tightening monetary policy gradually as price growth continues to move higher. The unemployment rate is set to fall further below the Fed's goal, signaling upward pressures on wages and prices. As nations around the world fail to achieve their price stability level, the US economy has accomplished its mission of a 2% inflation target. The above data further supports the era of economic divergence between the US and most major economies.

US GDP Revised Lower

The third and final reading from the US Commerce Department revealed that the American economy expanded at a slower pace than previously thought. The first quarter GDP came in at 2% from the previous estimate of 2.2%. The main factor for the softer data is attributed to the weakest performance in consumer spending in nearly five years. Consumer expenditure produced a 0.9% number in the first three months of the year after recording 4% in Q4 2017. Furthermore, Q1 GDP figures have the habit of being dull in recent

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years because of seasonal factors that statisticians struggle to strip away from the data, which also could have been a factor.

The recent positive data witnessed from the largest economy in the world indicates that the soft Q1 GDP reading was transitory and a rebound may soon be expected. Looking at anticipated figures, the Federal Reserve Bank of Atlanta’s GDPNow tracking estimate for Q2 expansion was at 3.8% as of Wednesday, while the median forecast in a Bloomberg survey of economists called for a 3.4% pace. The US economy is still outperforming other developed nations around the globe as economic figures diverge in America’s favor. In addition, the $1.5 trillion tax cut is seen encouraging faster economic momentum in the second quarter, putting annual GDP growth on track to achieve the Trump administration's 3% target. Nonetheless, the US policy of America first and the latest escalation in trade tariffs could disrupt supply chains and undercut business investment and potentially wipe out the positive effects of the fiscal stimulus.

US Consumer Sentiment Retreats as Trade Concerns Intensify

Consumer confidence retreated in June, falling to 126.4 down from May’s upwardly revised 128.8. The dip in confidence is being blamed on the escalating tensions between the US and its trading partners. Despite the downward momentum in confidence, prospects remain high by historical standards. The modest reduction in optimism just advocates the case that consumers do not expect the economy to gain much more momentum as it already has. The tensions on the horizon from the trade disputes may be starting to upset consumer confidence negatively, and that negativity may further persist if the current administration continues to take a tough stance on global trade. Even as sentiment diminishes, the economy is in better shape than its peers in terms of GDP growth, higher inflation, large number of job openings and lower taxes. The labor market is viewed as being near or at full employment, with the unemployment rate at an 18-year low of 3.8%. Several economists have warned that the Trump administration’s nationalist trade policies may counterbalance the boost to the economy from the $1.5 trillion tax cut package passed late last year.

As for the US dollar, the greenback had a positive performance last week despite the downward revision of Q1 GDP. Demand for the US dollar is strong especially in regards to interest rate returns and has the characteristics of a safe haven asset. Moreover, the divergence in economic performance between the US and many of the other major developed economies is another factor. On Wednesday, the Dollar received further support from the release of the latest US trade report. The report showed that the advanced goods trade deficit narrowed as exports increased by 2.1% on a monthly basis. In the last three months, exports soared 24.3%, while imports declined by 6.5%. The data supports the case for a stronger Q2 GDP figure. The Dollar index began the weekly session at 94.564, appreciated to a high of 95.531 and closed on Friday at 94.636.

UK & Europe

The Variance Between Headline & Core Inflation

The 19 countries sharing the euro currency witness annual price growth rising from 1.9% to 2% this month. The rise in inflation was related to higher food and energy prices, flash data from Eurostat indicated. The jump in oil rates has played a key role, with energy prices up 8% on the year, up by 1.9% from May’s data. Meanwhile, core inflation eased to 1% from 1.1%. It is obvious that the price of oil is the reason for the divergence between headline and underlying inflation. Wages are improving at an extremely slow pace, and it still appears doubtful that there are substantial upside surprises to the core inflation rate.

The outlook for the single economy is still uncertain as some entities blamed the sluggish first quarter on transitory reasons, while others indicate a longer lasting downward trend. That uncertainty coupled with subdued underlying price growth, helps explain the ECB's cautious approach to removing the stimulus it has been providing to the economy. Core inflation still lacks the convincing upward trend the ECB has been looking for before exiting its accommodative policy. However, Mario Draghi has already publicized the end

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of QE in December 2018, and the Bank claimed it wouldn't consider a rise in its key interest rate until the end of summer 2019.

German Business Moral Resumes Downward Trend

Looking into the German Business sentiment indicator, the index has declined six times in the past seven months. The data came in at 101.8 for the current month, down from the previous reading of 102.2. The current situation indicator slid to a 1-year low of 105.1 in June from a revised 106.1 in May. However, the positive news was that the future expectations component was revised to 98.6 after having declined in the five previous months. The above data is somewhat at odds with the PMIs released last week, which showed a better reading for the service PMI. Overall, both indicators point to reasonable growth rates ahead for the German economy, although the growth momentum has also clearly passed its peak. The prime risk to the economy continues to be a further escalation of trade tensions and the threat by the US government to impose 20% tariffs on auto imports from Europe was not incorporated in the ifo readings published last week.

The single currency started the week positively and rose to a 1-week high of 1.1720, supported by a sell-off in the US dollar. However, the positive momentum was short lived due concerns about an escalating trade conflict, which boosted the Dollar and the Japanese yen. Furthermore, the threat of a political crisis in Germany and uncertainty over the EU summit were also factors in the negative movement. At the end of the week, the euro reversed most of its losses after EU leaders reached an agreement on the migration issue. The agreement reduced pressure on the German Chancellor, which assisted to decrease the chances that Merkel's coalition government would fall apart. The latest consumer inflation report for the single economy had a hand in the euro’s appreciation too. EURUSD opened the week at 1.1669 and ended the weekly session almost unchanged at 1.1683.

The BoE’s Semiannual Financial Stability Report

The BoE has blamed the EU in its semiannual Financial Stability Report for risking the possibility that the notional amount of GBP 29 trillion worth of derivatives could become untradeable after March next year. Out of the 29 trillion, GBP 16 trillion is due to expire after Britain leaves the EU. Moreover, the progress on the Brexit front has been in standstill mode since March, increasing the risk of uncertainty, especially on complicated issues such as derivatives and border migration of products and individuals. Domestic risks to the financial system remained standard, the BoE claimed, while acknowledging global risks are substantial and have intensified.

As for external risks, the BoE’s financial committee has become more concerned on foreign risks. Tightening global monetary policy conditions and the rise in some government bond spreads at an era of a continuous elevation of risk on global trade. At the same time, the Bank was most alarmed on greater vulnerabilities in emerging markets, where weaker exchange rates compared with the US dollar and higher US interest rates had significantly increased debt servicing obligations. These loans accounted for 15% of UK banks’ exposures. On the positive front, the central bank stated that banks in the UK are resilient enough to survive any downturn as large as the 2008-09 financial crisis and added that the stress test was sufficient to cover risks associated with a hard Brexit. Overall, the main difficulties for the British economy is the uncertainty of the Brexit outcome, global trade disputes, the exposure of British banks to derivatives contracts and emerging market loans.

UK Q1 GDP Revised Slightly Higher

Thanks to the British service sector, UK Q1 GDP was revised slightly higher to 0.2%, from the prior assessment of 0.1%. The services industry accounts for the majority of UK’s GDP data and the sector expanded 1.6% y/y. However, the upgrade did not support annual GDP as the number stayed constant at 1.2% for the first quarter of 2018. Households were still net borrowers for the fourth successive quarter mainly due to high inflation levels. The BoE expects GDP to inflate by 0.4% in Q2 after the harsh weather conditions in the first quarter. The central bank will be pleased to see the upward revision. The BoE believes the Q1 slowdown is temporary and expects it to be revised up to 0.3% m/m eventually. The

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modification reinforces the case of those MPC members wanting an immediate rate rise. As always, however, the story isn't quite so simple. The upward revision was not broad-based across the economy and was concentrated in a specific sector. Overall, the data aided interest rate probability of an August rate rise by the BoE to 60% from 50%.

It was a light week in terms of economic data for the Sterling pound and the currency's volatility was mostly correlated to US dollar trajectory. The GBPUSD depreciated last week to 1.3048, a 7 months low. The only major indicator (UK GDP) helped the pound to recover some of the extreme losses witnesses last week. The GBP lost 0.44% of its value to the Dollar in the last five trading sessions.

Asia

Japan's Inflation Conundrum

Most major central banks around the globe have set a price growth target of 2%. Nowhere, though, does the pursuit for this figure carry drama like it does in Japan, where BoJ's Governor Kuroda has promised to do whatever it takes to achieve its inflation target. When the central bank implemented its loose monetary policy program, oil was near $100 a barrel. In 2014, prices sank and later fell below $40 a barrel. Hence, in a country that imports most of its fuel may find it extremely difficult to raise inflation when oil prices were subdued. Secondly, Japan's elderly aged 65 and older account for a third of the residents and many of them are concerned about their retirement life due to inadequate pension and financial assets. So obviously, this segment of the population will think twice before squeezing their pockets. That's why households' demand has been very elastic to the prices of daily goods and services to a degree that firms find it very problematic to increase their prices steadily. A latest instance occurred this year during the January-March quarter, when the contribution of consumption to real GDP growth turned negative due to higher food prices caused by bad weather.

The Bank of Japan latest Core CPI data, the bank's preferred inflation indicator, slipped to 0.5%, shy of the 0.6% estimate. With the current level of price growth in Japan and the latest summary of opinions of the June policy meeting, suggest policy makers are in no hurry to exit the current monetary strategy. Policy setters advised the Bank to continue its massive easing program. At the same time, several members on the committee voiced their concerns that the program had undesirable side effects, such as ultra-low rates hurting the profitability of banks. At the June meeting, the BoJ maintained its monetary policy and lowered its inflation forecast. With inflation stuck below the BoJ's target of just under 2%, the BoJ is broadly expected to continue with its easing scheme well into 2019.

The safe haven Japanese yen had a negative weekly session despite worries of a trade war. It seems that the US dollar is in more demand as interest rates continue to widen. Hence, investors are parking their liquidity in Dollar safety rather than yen safety. The yen lost further momentum on the last trading day after the EU summit concluded the migration issue. The yen lost 71 basis points to the USD last week.

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Kuwait

Kuwaiti Dinar at 0.30250

The USDKWD opened at 0.30250 on Sunday morning.

Rates – 1 July, 2018

	Previous Week Levels				This Week's Expected Range		3-Month
Currencies	Open	Low	High	Close	Minimum	Maximum	Forward
EUR	1.1669	1.1525	1.1720	1.1683	1.1560	1.1870	1.1768
GBP	1.3268	1.3048	1.3289	1.3210	1.3000	1.3400	1.3268
JPY	109.92	109.35	110.93	110.66	108.55	112.40	109.99
CHF	0.9875	0.9852	0.9992	0.9902	0.9705	1.0100	0.9834

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