# Treasury Group

**Weekly Money Market Report**

11 June 2017

# Hung Parliament in the UK Complicates the Brexit Situation

## United States

### Uncertainty Resurfaces in Britain

Last week, UK Prime Minster Theresa May's Conservative party lost its parliamentary majority in the highly awaited general election. The result had caught the market off guard, as investors expected Theresa May to increase her majority in parliament, to strengthen her position ahead of crucial Brexit talks. The Sterling fell sharply as the outcome of the election fueled more confusion about the UK's political situation and the upcoming Brexit negotiations.

Furthermore, with less than two weeks for Brexit negotiations, the British government will have less domestic support to negotiate the Brexit process. On the other side, political turmoil in Britain is a gloomy scenario for EU leaders who want to press ahead quickly with Brexit talks as the current situation might prompt the UK to postpone talks until a coalition is formed.

In Europe, the single economy has been gaining upside momentum since the start of the year, leading to expectations of a change in tone from the ECB. Markets expectations were disappointed on Thursday when the ECB refrained from mentioning the pace of tapering their accommodative policies.

On the currency front, the dollar index began the week on a downward trend after the yield on 10-year US Treasuries fell to 2.13%, the lowest since November 10. The lower yield is attributed to political tension in the Middle East, uncertainties over U.K. election and most importantly the outcome of former FBI director James Comey. However, the index recovered as Comey’s testimony did not provide any major revelations that can lead to an impeachment of U.S. President Donald Trump. The DXY opened at 96.76 on Monday and rose to the highest since May 31st at 97.48.

The single currency was trading in a tight range at the start of last week, as markets were cautious ahead of Super Thursday and no major economic data was released. All that changed after Draghis conservative comments and inflation forecasts were revised lower, the EURUSD began its sharp descent. The pair started the weekly session at 1.1276 and ended on Friday at 1.1192.

The Sterling pound was firm versus the U.S. dollar at the beginning of the week and rose to the highest level since May 25 at 1.2977. On Thursday night after the election results the pair dropped from 1.2962 to 1.2704 and continued its depreciation onto Friday’s session to a low of 1.2632, the lowest since April 18. Sterling recovered some of its losses amid announcements that UK Prime Minister would form a government with the support of the Democratic Unionist Party. The news helped the currency, as investors hoped that the potential formation of a Conservative-DUP coalition could help the UK avoid a hard Brexit.

In the commodities complex, the precious metal was near 7 months high of $1,296.00 on Wednesday as global political uncertainties drove up the demand for safe haven assets. The ECB meeting and Comey’s testimony on Thursday were a non-event, causing the price of gold to depreciate. The yellow metal ended the week at $1,265.90.

### U.S. Job Openings at a Record High

In the U.S., the number of job openings in April rose to the highest level since the survey began in December 2000, however employers may be having trouble finding qualified applicants as the labor market tightens. Total job vacancies increased 6.04 million from 5.8 million in March, and was higher than forecasted. The number of employees who voluntarily leave their jobs, eased slightly to 2.1% in April, but remains near 10-year highs. The data supports the Fed to raise interest rates next month.

### Weak Orders for the U.S. Economy

In May, economic activity in the non-manufacturing sector remained in expansionary mode since 2009, although the index fell by 0.6 points coming at 56.9. The latest data remains solid in respect to historical figures. Business activity dipped 1.7% and new orders were down 5.5%. On the positive side, employment soared 6.4% to 57.8, showing growth for the 39th consecutive month. ISM stated that 17 of 18 sectors reported growth in May. Looking at the state of non-manufacturing sector since the beginning of 2017 the data was better than anticipated.

Growth in U.S. factory orders have been declining for 3 months consecutively and posted its first contraction in April since November 2016. In the month of April, factory orders slipped -0.2% from 1% in March. The weakness in manufacturing products is attributed to orders for durable goods declining by 0.8% for the month.
Machinery orders posted its biggest drop of 0.7% since October, while mining, oilfield and gas field machinery orders fell 8.3% month on month. However, on a yearly basis factory orders were up 4.4% from a year ago. Looking at auto sales demand, which have softened from last year and the government reported that employment at motor vehicles and parts manufacturers fell by 1,500 jobs in May. This may hurt production in the coming months.

## Europe & UK

### Never Underestimate Draghi's Dovishness

In its latest policy setting discussion, the European Central Bank closed the door on further interest rate cuts, while refrained from discussing about tapering process. The bank did not address any policy changes, while lowering inflation projections. The ECB predicts inflation at just 1.5% this year, down from the earlier forecast of 1.7% and would barely rise to 1.6% in 2019.

The main issue is inflation, which remains weak. Unemployment rate is on a downward trend, but wages are stable as many individuals take part-time or lower wage jobs. Draghi stated inflation indicators "have yet to show convincing signs of a pickup." On the updated economic projections, the bank expects growth to expand 1.9% this year, up 0.1% from the previous estimation. It also increased its growth projection for 2018 to 1.8% from 1.7%, and for 2019 to 1.7% from 1.6%. The ECB president also expressed more confidence in the economy.

Overall, markets were expecting a more hawkish stance from the ECB, while Draghi tone was ever so cautiously towards monetary tightening. The central bank's main job is to control inflation. As long as price growth remains subdued, the bank will feel obligated to keep supporting the economy.

### The Robust European Momentum

The Eurozone economy seems to be tilting to the upside since the beginning of the year as economic growth continues to accelerate at the fastest pace in 6 years. According to IHS Markit, the Composite Output Index posted a reading of 56.8 in May and was unchanged from the preceding month. The data was supported by strong growth of incoming new business and orders; brightening Europe's one year future output to the highest level since data for this series were first collected in July 2012. Germany and France's output growth is currently around 72 months high.

In the service sector, Europe's rate of progress remained nearly unchanged in May at 56.3 with Spain recording the steepest rate of expansion of 57.3. The continuous improving condition in the service sector was reflected positively on business confidence, which hit an 85-month high in May. Robust figures of new orders across Europe's largest economies has encouraged job creation, with France's pace of job creation accelerating to the highest since August 2011. The latest PMI readings indicate the Eurozone is enjoying a strong second quarter, consistent with GDP rising at a 0.7% rate.

Despite the positive outlook for the German economy, factory orders fell in April as demand from overseas tumbled 3.4% and orders from non-Eurozone areas plunged 4.8%. However, the indicator is known to be volatile and the drop will not be enough dampen Europe's largest economy.

The German economy has been robust so far this year, expanding at a 0.6% at the start of the year and above the Eurozone average. Unemployment is at a record low and falling, while business confidence is at the highest level since 1991. The Bundesbank expects the economy will continue to expand at a robust pace in the coming months, supported by foreign and domestic demand.

### UK's Economy in Contraction Mode

Industrial sector grew slightly for the first time this year, after falling in each of the previous three months. The sector grew 0.2% in April, coming in below expectations of a 0.8% increase. The slight expansion was driven by an increase in energy production and stronger factory output. The slowdown in the economy in the first quarter was sharper than previously thought. Britain's economic slowdown in the first three months of 2017 made it the worst performer among the G7 nations.

Britain’s service sector slowed in May as business activity rose at weakest pace since February. The slow growth in the sector is attributed to lower growth in new orders and weak consumer spending. However, IHS Markit stated they perhaps exaggerated the pessimistic mood because the slowdown in the growth of new orders was partly due to companies delaying decision-making ahead of the election.

The service index fell from a four month high of 55.8 to 53.8. Overall, weaker data since the start of 2017 shows how vulnerable the sector can be under pressure amid political uncertainty. Since the vote to leave the European Union, British citizens have been impacted by high inflation and low wage growth, translating into lower living standards. The service sector accounts 80% of UK’s economic activity, which is highly sensitive towards consumer spending.

## Asia

### China’s Yearly Trade Balance Slightly Shrinks

The Chinese economy defied expectations in May after Moody's downgraded its credit for the first time in 30 years as the country's financial strength will weaken in coming years due to slower growth and debt continues to rise in a period higher funding costs. The Chinese trade balance widened $2.76 billion in May to $40.81 billion, but came in below expectations of $46.32 billion. On a yearly basis, the deficit shrank around $4 billion as exports rose less than imports. Exports and imports rose 8% and 11.9% respectively.

The World Trade Organization expects global merchandise trade to grow 2.4%, from last year’s 1.3% and predicts the Chinese economy to expand moderately in the second quarter. Overall, the economy may witness some difficulties as the government is looking to de-risk the banking system and to control debt and housing risks.

### Mixed Chinese Inflation

Prices paid by producers were subdued for a third consecutive month in May, indicating an economic cool down as profits are squeezed by weak domestic demand and rising financing costs. The downward pressure on PPI was also affected by lower commodity prices. On a yearly basis, producer prices were elevated by 5.5% in May, down from April’s 6.4%.

Falling producer prices in China could be a problem for major central banks globally as they try to reach their inflation target. Markets expect China’s economy to cool in the months ahead, with the latest factory activity figures also suggesting a gradual slowdown. On the other hand, consumer inflation jumped to a four-month high of 1.5, from 1.2% in April. Inflation is currently well below the government's target of around 3% for the year of 2017.

### Japans GDP Revised Lower

Japan’s economy expanded at a slower rate than previously anticipated by the Cabinet Office. The final annualized value of goods and services produced in Q1 2017 was downgraded from 2.2% to 1%. The state of the economy was weighed down by a drop in oil inventories, raw materials and a slower pace of growth in private consumption. On a quarterly period, GDP grew 0.3% compared with the first estimate of 0.5%.

Even with the lower growth, the economy has recorded its longest sustained run of growth in more than a decade, with five quarters of continuous economic expansion. Although, the continuous expansion has not translated into higher wages and the BoJ is far from reaching its 2% inflation target. The latest data may prolong Japan’s loose monetary policy.

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## Kuwait

### Kuwaiti Dinar at 0.30340
The USDKWD opened at 0.30340 on Sunday morning.

## Rates – 8th June, 2017

| | Previous Week Levels | | | | This Week's Expected Range | | 3-Month |
|---|---|---|---|---|---|---|---|
| Currencies | Open | Low | High | Close | Minimum | Maximum | Forward |
| EUR | 1.1276 | 1.1165 | 1.1283 | 1.1192 | 1.1210 | 1.1345 | 1.1254 |
| GBP | 1.2868 | 1.2632 | 1.2977 | 1.2746 | 1.2550 | 1.2860 | 1.2787 |
| JPY | 110.47 | 109.09 | 110.80 | 110.33 | 108.10 | 111.30 | 109.92 |
| CHF | 0.9630 | 0.9612 | 0.9727 | 0.9694 | 0.9530 | 0.9860 | 0.9642 |