Strong US labor market and easing tensions in Italy lift markets, but trade war concerns intensify

Overview

The news that US jobs growth picked up in May and unemployment fell to an 18-year low gave markets an end-week boost, with the S&P 500 rising 1.1% on Friday, benchmark US and European bond yields edging up and the US dollar slightly firmer. Markets also cheered an easing in political tensions in both Italy and Spain, with the former agreeing a new coalition government that, although anti-establishment in nature, reduces the risk of fresh elections. Looking forward, these positive developments may be offset by trade disputes, with EU officials vowing to respond to the ending of a waver that will see the US apply tariffs on imports of steel and aluminium from Europe and North America, ratcheting up trade fears. Other G7 countries condemned the US’s move.

The price of Brent crude edged up 0.5% following the previous week’s sharp decline, finishing at just below $77/bbl. The market continues to digest the potential for an easing in OPEC-led supply cuts through 2018, though mid-week reports suggesting that existing production might be raised only gradually this year saw crude recover its earlier losses. Meanwhile however, the price of the US benchmark WTI fell 3% w/w to $66, its largest discount to Brent in over three years as the run-up in oil prices this year has improved the fiscal and external current accounts positions and led to a surge in international reserves. For Bahrain though, a small oil producer, the IMF has called for the government to urgently implement a ‘credibly large fiscal adjustment’ in order to address a still-large fiscal deficit, rising debt and low financial reserves.

Regionally, the run-up in oil prices this year has improved the fiscal and external current accounts positions and led to a surge in international reserves. For Bahrain though, a small oil producer, the IMF has called for the government to urgently implement a ‘credibly large fiscal adjustment’ in order to address a still-large fiscal deficit, rising debt and low financial reserves.

International macroeconomics

USA: As expected, GDP growth in 1Q18 was revised down to an annualized pace of 2.2% from 2.3% before on the back of slightly softer consumer spending and weaker inventories. Current expectations are for growth rebound closer to the 3% mark in Q2. But Friday’s news from the labor market was more upbeat, with employment surging 223,000 in May – well above expectations – and unemployment falling to an 18-year low of 3.8%. (Chart 1.) Earnings growth edged up to 2.7%
y/y from 2.6% in April and the report was seen as cementing the case for a Fed rate hike later this month.

Data from earlier in the week also revealed a consumer sector in decent shape. Consumer spending rose a solid 0.6% m/m in April, though the closely-watched core PCE inflation measure was unchanged at 1.8% y/y. Meanwhile, the Conference Board’s gauge of consumer confidence edged up to 128 in May from 126 in April – close to recent 17-year highs – and the Case-Schiller house price index rose a solid 0.5% m/m in March, leaving the annual rate unchanged at 6.8% y/y.

Key surveys of manufacturing activity for May were also very strong, with the PMI broadly unchanged at 58.4 while the ISM gauge rose to 57.3 in April. Both surveys signaled strong order books, rising backlogs, delivery delays, and also hinted at rising selling prices reflecting capacity constraints in the sector.

Eurozone: Politics remained at the forefront in the Eurozone. A turbulent week for Italy ended with a sigh of relief, with Italy’s president accepting the populist coalition’s government following staunch opposition earlier in the week. Meanwhile, Spain’s prime minister was defeated in a no-confidence vote sparked by a campaign scandal, and was forced to step down.

Eurozone data was mixed. Economic sentiment was little changed, edging down 0.2 m/m to 112.5. Weakness in industry and services was offset by increases in retail and construction. Headline inflation, on the other hand, increased to 1.9% in May from 1.6% in April on higher oil prices, and the core rate climbed to 1.1%. The manufacturing PMI fell for a fifth consecutive month, on weaker external demand.

GCC & regional macroeconomics

Kuwait: The trade surplus picked up in 1Q18 by 19% q/q and 43% y/y, reaching KD 2.3 billion from KD1.9 billion in 4Q17. The strong improvement occurred due to a recovery in both oil and non-oil exports. Oil exports reached KD 4.4 billion in the first quarter, up 18.7% y/y, helped by a 23% rise in the price of Kuwait Export Crude. Non-oil exports jumped 26% y/y to KD 372 million. Import growth was moderate at 3.4% y/y.

Saudi Arabia: Saudi foreign reserves in April topped $500 billion for the first time since June 2017. Thanks to higher oil prices which have led to the return of current account surpluses, official reserves have grown for two consecutive months (+$13.2bn in April) to reach $506.6 billion; annual growth, at 1.3% y/y, also turned positive for the first time in more than three years. (Chart 2.)

However, both private sector credit and deposit growth remain lackluster at 0.7% y/y and 1.5% y/y in April, respectively. (Chart 3.)

These figures are still quite a way below rates of growth in the pre-2014 oil downturn period. In the case of bank credit, borrowing by manufacturing, commercial and construction firms remains especially weak.
Bahrain: S&P affirmed Bahrain’s long and short-term foreign and local currency sovereign ratings at B+/B and maintained its stable outlook for Bahrain on the basis of the kingdom’s continued access to foreign capital. Financial assistance from regional allies and access to international funding, through sovereign debt issuances, for example, have been instrumental in helping Bahrain to replenish its reserves (which fell to the equivalent of a mere 1.4 months of imports earlier this year).

Nonetheless, following the conclusion of its mission in Bahrain, the IMF reiterated the need for fiscal reform to reduce its stubbornly-large fiscal deficit and to support the currency. The government has reportedly said that it would reduce its fiscal deficit to 11% of GDP in 2018 from around 14% in 2017. The IMF expects the economy to grow 3.2% in 2018, led by a recovery in oil production, GCC-funded infrastructure projects and an expansion in refinery and aluminum capacity.

Turkey: In a bid to stem the steep decline in the Turkish lira, Turkey’s central bank held an emergency meeting last week during which it raised its interest rates by 300 bps and announced that it would return to using the one-week repo rate as its benchmark interest rate, to help simplify and improve the predictability of its policy. The lira gained some 2% following the meeting but pared its gains by the end of the week, as concerns about Turkey’s double-digit inflation rate (data due on Monday) weighed on sentiment.

Markets – oil

Oil prices closed last week with the two major crude benchmarks pursuing different trajectories. While Brent closed up 0.5% w/w at $76.8/bbl, WTI, the US marker, fell 3% to $65.8/bbl – the second consecutive weekly fall and the marker’s lowest level in a month. (Chart 4.)

Retreating oil prices, weaker global sentiment and concerns over the newly announced visa programs initially weighed on regional markets, but turned around helped by the recovery in oil prices. The MSCI GCC index finished the week 1.2% higher.

Markets – equities

Global equity markets were driven by the political uncertainty that surrounded Italy, while trade disputes also weighed. The MSCI AC index declined 0.1% w/w.

US equities sold-off on Tuesday before almost recovering completely on Wednesday following some easing in political tensions in Italy, but protectionist trade rhetoric from Washington dampened the recovery. The S&P 500 was up 0.5%, while the DAX declined by 0.5%. Europe’s Stoxx 50 pared back some losses following the Italian resolution, but was held back by the ousting of Spain’s PM. The index was down 1.8% w/w. Meanwhile, trade war concerns kept emerging markets on edge, with the MSCI EM retreating 0.5%. (Chart 5.)

Chart 5: Total equity return indices

(Rebased, 6 June 2017=100)

Source: Thomson Reuters Datastream

Oil prices have generally been on the back foot since Saudi Arabia and Russia indicated in late May that they could open the taps as soon as the end of this month (after the OPEC meeting on June 22) the divergence in the two crude benchmarks is a reflection of local US oil market dynamics. Last Friday, the spread between the two markers reached $11/bbl – the highest since 2015 – as surging US crude output (+44 kb/d to 10.77 mb/d in w/e 25 May) is swamping local transport and storage infrastructure, overloading pipeline capacities.

Property and banking shares in Abu Dhabi (+0.1%) and Dubai (+0.3%) led the sell-off earlier in the week but rebounded later on firmer oil prices. Saudi (+1.5%) also benefited from higher oil prices, as well as the anticipation surrounding its ascension to MSCI’s emerging market index – expected June 20. Qatar (-1.9%), however, experienced some profit taking, while Kuwait was little changed. (Chart 6.)
Markets – fixed income

The turmoil in Europe and President Trump’s confrontational trade position has favored safe havens, with bond prices up on the week despite an end-week decline on stronger US data and as Italian political tensions eased. US 10-year yields dropped 4 basis points to 2.90%, while 10-year Bunds shed 3 bps, to settle at 0.38%, close to their lowest levels since December. (Chart 7.)

Concerns over Italy and Spain have put into question Eurozone growth, and by extension global growth. This in addition to more protectionist trade rhetoric shifted expectations of four rate hikes by the US Fed in 2018 lower to 30% from 47% more than a month ago.

GCC yields were mixed, as uncertainty over OPEC oil production had somewhat offset the down pull of US treasuries. (Chart 8.)
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