International scene

Political factors on the rise ahead

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As we approach year-end, 2016 eerily resembles 2015: unimpressive but "acceptable" world growth, central banks hell-bent on aggressive non-conventional policies, except for the Federal Reserve, which is likely to repeat its 2015 feat of a measly 25 bps hike in December of that year. However, to poach the old aphorism "history does not repeat itself, but it often rhymes," well, so does the economy. Away from the rhyming part, the rest of the background is slowly changing; in new and uncharted ways and in politics and in economics, now and ahead.

On politics, the Brexit vote in June was not the immediate catastrophe that many had feared. The difficult part starts next year, when the UK begins exit negotiations in earnest. Only then, will more clarity come about, and markets will get a better feel of how contentious the issue may get. Similar issues may be brewing elsewhere in Europe. Italy will hold an important constitutional referendum in November that may well determine the future of the current government, as well as the ability of the country to reform. France will hold a presidential election in 2017. These events and others are taking place with populism and anti-establishment sentiment on the rise, both in Europe and in the US. The latter will hold its presidential election on November 8 of this year, with the unconventional outsider Donald Trump in close contention. These events and others are bound to inject more questions than answers for the markets in the months ahead.

These shifting political grounds are occurring while policy and policy-makers appear near exhausted. Policy makers and investors alike are beginning to realize that current policies, especially the monetary kind, have perhaps reached their limit, and that the options will be scant should any major economy hit a big pothole. After zero, even negative interest rates in some cases, and the recent massive QE programs, where are we? The Fed is still trying to find a window to "normalize" its policy rates (and missing opportunities). The ECB is promising further accommodation, but is taking its time in the hope that "things" improve and perhaps in the face of its own doubts(?). The BOJ remains committed to pushing Japanese retail inflation from "negative" to 2.0%, via new innovative moves: pumping up the monetary base, and targeting the 10-year interest rate at 0.0%, atop the previous aggressive QE measures already in place. Here again, doubts are being raised as to the efficacy of monetary policy (the Yen rose throughout this year). Furthermore, zero-to-negative rates seem on the verge of becoming a potent political issue, hurting savers and retirees, especially in the current volatile political times. Finally, should the need arise for other policy options, needless to say fiscal options are very limited with current debt levels at record highs. Economic restructuring and reforms are made very difficult by the contentious/dysfunctional politics of the day.

Thus, politics is bound to be as important as economics in the period ahead, and caution is warranted. And while most "baseline" forecasts argue for a steady, albeit modest, growth environment in the next year or two, any significant deviation on the lower side could have more market impact than usual because it would further charge the politics, and there are no guarantees that financial markets would be as welcoming of further central bank accommodation as in the past.

In this type of environment, so far this year, interest rates have fallen dramatically in the EU and in Japan, to negative levels. The dollar has been in a range versus the Euro, and the Japanese Yen has risen to the BOJ's chagrin. Stocks have moved up in most advanced markets, led by the US where equities made new all-time highs recently before retreating some. For their part, UK stocks are up post-Brexit, though the pound lost major ground.

Consensus projections for world growth in 2017 are close to the IMF's 3.4% (3.1% in 2016), with the US at 1.8%, the Eurozone at 1.6%, Japan at 0.5%, and emerging markets at 4.6%. The central banks are expected to do "whatever is necessary" to keep things going, In that environment the price of oil is expected to recover very gradually toward $60 pb in late 2017, as supply continues to outpace demand, and with OPEC wielding much less control than in the past.

Besides the Italian referendum and the US presidential election this November, the Fed will dominate the agenda in Q4, at its December meeting. Ever so cautious, the Fed has kept postponing the "expected" Fed hike(s) for the year, now down to one hike. Between international developments (Brexit) and some soft data out of the US (PMIs, sales), the Fed decided at its September meeting to leave policy rates unchanged, though three FOMC members did dissent, pushing for a rate hike. "Three dissenters" is on the high side for the Fed and indicates that Fed Chair Yellen is having a harder time postponing raising rates. The November Fed meeting is assumed to be a "dead" meeting (no change) because it takes place one week before the US election. So, barring a change in US data, or financial market turmoil before yearend, the Fed should be raising rates 25 bps on December 14 (the federal funds rate target). The September Fed's dot-plots are finally in line with the current market expectation for 2016 of one interest rate hike. However, as usual, the Fed anticipates more action than the market does for 2017. The markets are looking for 2 hikes next year, and these have certainly been more "right" than the Fed the past few years.

As to the US elections, any change will be more gradual and less dramatic than feared, especially if no party sweeps the elections, i.e. Congress and the presidency. A Clinton win with a Republican Congress would be the least change prone, and therefore the most "stable" for the markets. A Trump presidency would create more nervousness initially, but there again even a Republican Congress would still act as a check. Under Trump, fiscal stimulus would be more expansive than with Clinton (tax cuts, infrastructure spending), and deregulation would be more pro-business. So in such a very stimulative scenario, the Fed may raise rates faster in 2017 (versus a Clinton Administration). Also, Trump's anti-status-quo politics could have more of a spillover effect into European politics. At any rate, many of these developments will have to be gauged as they unfold, including any significant changes to international trade policy.

In the GCC, we continue to expect moderate GDP growth in 2016 especially if oil prices continue to improve from current levels. Governments remain committed to infrastructure spending. Adjustments to budgets are still ongoing, but continue to be gradual, as policy makers are keen on supporting GDP growth. Non-oil GDP growth should post 3.5% for the region the period ahead, somewhat lower than our previous projection. All GCC countries have started issuing sovereign debt in order to finance their deficits. Debt issuance is still pressuring liquidity but governments and central banks are addressing the issue adequately when needed, thanks to their ample reserves.

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