Treasury Group

Weekly Money Market Report

9 April 2017

Flight to Safety on Increased Political Tensions

United States

FOMC projections ignore Trump’s Fiscal Stimulus Promises

President Trump’s failure to gather sufficient support in Congress to pass changes to the Obamacare program has raised concerns over his ability to deliver other fiscal stimulus promises that he had made during the presidential campaign, such as cutting taxes and increasing spending on infrastructure projects.

The latest FOMC minutes statement echoed those concerns as some members have “continued to underscore the considerable uncertainty about the timing and nature of potential changes to fiscal policies as well as the size of the effects of such changes on economic activity”. Accordingly, several members expected that fiscal stimulus will not commence this year and, accordingly, did not alter their economic projections.

The minutes statement also showed that equity prices remain high relative to standard valuations measures, and that prices of other risky assets, such as emerging market stocks, high yield corporate bonds, and commercial real estate, have increased considerably recently.

The FOMC minutes statement also showed that there seems to be a disagreement amongst the policy members as to the direction of inflation in 2017. Some members “cautioned that the progress on inflation should not be overstated given that it had run persistently below 2% during the expansion and that core inflation was little changed in recent months.”

On the currencies front, the Dollar index gained positive momentum at the start of the week, supported by expectations of higher interest rates. The index reached a 20-day high of 100.95 ahead of the U.S. nonfarm payroll report, boosted by robust private sector job gains. The DXY opened the week at 100.39 and closed the weekly session at 101.130.

It was a tough week for the Sterling Pound as the majority of reports released last week came in negative and missed market expectations. The GBP/USD started the week at 1.2550 and descended to a low of 1.2380. The pair ended Friday’s session at 1.2372.

The USD/JPY began on a negative tone last week after the bearish reaction towards the ISM Manufacturing PMI data. However, the pair revered some of its losses after the release of the U.S. private sector job growth figure. The USD/JPY opened the week at 111.32 and ended the weekly session at 111.05.

In the commodities space, the price of oil was on a five- day gaining streak last week as speculators continue to bet on the prospect of market tightening. Brent hit its highest level in one month after the U.S. airstrike on Syria, despite of the U.S. Energy Information Administration report which showed that crude oil inventories have increased by 7.4% year on year to a record high of 535.5 million barrels last week.

On Friday morning, demand for safe haven assets increased after political tensions between the U.S. and Russia escalated following the U.S. airstrike on Syria. The yield on the 10-year U.S. Treasury fell below 2.29% for the first time since November 30th while the yield on Germany's 10-year government bonds declined by 2.5 basis points to a one-month low.

The Discussion has shifted to a Balance sheet Reduction

The minutes of the latest FOMC meeting showed that the committee discussed the size of the Fed’s balance sheet and how to reduce it. Most participants saw changes in the reinvestment policy happening later in the year, but views were mixed on how and when the changes would occur.

On monetary policy, nearly all Fed officials thought the U.S. was at full employment, but there were no clear indications that policymakers were ready to pull the tightening trigger again as soon as next month. Overall economic risks were generally portrayed as balanced, although the risks were biased as to what to expect from the potential fiscal policies from the new administration.

Philadelphia Fed President Harker also spoke this week mentioning that the Fed could begin to reduce its bond portfolio as early as this year. "Possibly by the end of this year or the beginning of next year would be an appropriate time to stop reinvesting maturing assets, but that's all dependent on how the economy evolves between now and then".

US Labor Supports Further Tightening Despite Soft Payrolls Data

The latest ADP figures showed that U.S. businesses added the most jobs in more than two years in March. The private sector added 263,000 jobs up by 18,000 from the previous month, versus a forecast of 184,000. The data continues to provide further evidence that the U.S. labor market finished the first quarter on a strong note and supports the Federal Reserve decision to tighten its loose monetary policy.

Looking at the non-farm payroll, employers hired fewer workers than expected in March as 29,750 employees left the retail sector and winter storms weighed on economic activity. The economy added only 98,000 jobs versus expectations of 180,000. On the other hand, the unemployment rate fell sharply to a 10-year low at 4.5%. Moreover, average hourly earnings rose by 5 cents or 0.2%, after a 0.3% increase in the previous month. Year on year, average hourly earnings eased to 2.7%.

The soft payrolls data could raise concerns about the economy's health especially given signs that gross domestic product may have slowed to around 1.0% in the first quarter of 2017. With rising inflation, moderate job growth and gradual wage gains, the Federal Reserve may stay on course to raise interest rates again in June.

On the manufacturing front, the sector still remains in expansionary mode with the PMI slightly falling by 0.5% to 57.2 in March. New orders fell by 0.6% and the production index declined by 5.3%, while the employment and price index increased by 4.7% and 2.5% respectively. Overall, the continuous increase in consumer demand and the turnaround in energy production accompanied by a weaker U.S. Dollar continue to support the index.

Europe & UK

No reassessment of the current monetary policy… for now

The ECB president said last week that a pick-up in inflation across the Euro area isn't yet strong enough and that "a reassessment of the current monetary policy stance is not warranted at this stage."

Complacency Sets in France

Less than a month to the French election, it seems that investors don't seem to allocate much risk premium to the election result any more. Although currency markets are still favoring the USD over the lower yielders, investors are pricing in a much smoother path through the two rounds than they did few weeks ago.

With the underperformance of populists in Europe, especially during the latest French presidential debate alongside the market focusing on potential ECB rate hikes, markets seem to have priced out the possibility of a Le Pen win. Although our base case scenario remains that the French elections result will not yield a Le pen victory, volatility could easily return, at least for the first round of the election.

Germany Enjoying the Weak Euro

German factory orders rebounded sharply in February from January's 6.8% contraction. The increase was mainly due to an 8.1% jump in domestic demand, while demand for producer goods surged 8.5%. Foreign orders were mainly flat and new orders to the Eurozone fell by 2.4%.

The data suggests that the private sector is likely to continue to accelerate due to a stronger domestic demand in a period of high optimism in business confidence.

Despite the positive figures, European political risks continue to overshadow the optimism towards Germany as uncertainty over U.S. trade policies, Brexit negotiations and September's federal election continue to pressure future prospects and investments.

Politics starting to take a toll on UK Data

According to the UK Prime Minister, Britain may not finalize a new trade deal with the EU until after Brexit is complete in 2019. These comments have brought the UK more closely in line with the EU's Brexit negotiating draft, which says that the two-year talks between the UK and EU might include only a "framework for the future relationship". The European Council has insisted that a final trade deal would have to be concluded with the UK as a third country; i.e. after it has left the EU.

On the economic front, the UK economic data continues to falter with the construction sector expanding at a slower pace once again in the month of March. The construction PMI declined by 0.3 points to 52.2, below expectations of 52.5. The slower growth is attributed to a weaker trend for residential work as rising inflation has started eating into consumer's demand and businesses.
Since the "Brexit" vote, Britain's economy outperformed all European Group of Seven in 2016; however, growth is expected to slow down this year as rising inflation starts to take its toll on the economy.

Other economic data were also under pressure with UK's manufacturing PMI declining for a third consecutive month in March. High inflationary pressures in Britain caused export orders to expand at a slower rate and demand for consumer goods to lose momentum. Looking at the data, manufacturing PMI slipped for the month of March by 0.3 points to 54.2. However, the index is above the long run average of 51.6.

The service sector on the other hand held up and reversed two months of declining PMI readings in March and reached three months high. The index climbed by 1.7 points settling at 55 against a consensus of 53.5. If the combination of resilient economic data and higher inflationary pressures continue, interest rate expectations could change, with the market currently only pricing in a 50% probability of rate hike by December 2018.

Asia

Despite the Strong Data, Kuroda Dismiss Markets' Speculations

According to a survey released by the Bank of Japan, business confidence improved in the first quarter of 2017. The Tankan Manufacturing Index rose to 12 points, up from 10 in Q4 and non-manufacturing sector improved by 2 points to 20. Across all industries, conditions also improved by 2 points to 16.

As mentioned last week, the latest Japanese economic data continue to show an expansion in the first quarter of 2017, mainly led by solid exports and firmer capital expenditure. Moreover, the latest Japanese trade data showed a surplus rebounding in February as Japanese exports rose for the third straight month by 11.3%.

Replying to speculation that the BoJ might be looking at options for reducing its extraordinary monetary stimulus program, Bank of Japan Governor Kuroda mentioned it was too early to discuss an exit strategy from the central bank's current monetary policy. Kuroda also said the BoJ's equities purchases were aimed at meeting the 2% inflation target and don't distort the price mechanism for stocks.

Chinese PMI Showing Sign of Exhaustion

On the economic side, operating conditions in most private service companies expanded at a slower pace for a third consecutive month in March. The survey indicated costs incurred by service companies inflated at the fastest pace since February 2013. Hence, businesses transferred the higher costs on to their clients causing business activities and new orders to grow at a slower rate.

The Chinese Composite PMI released earlier came at 52.2 in March, falling from February's 52.6 recording the slowest increase in Chinese business activity in six months. Weaker increases in new business have clouded the economic outlook as the service industry has become an increasingly important part of the Chinese economy, reflecting its shift away from traditional heavy-industry manufacturing and exports.

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Trump's meeting with Xi

The first meeting between President Trump and Chinese President Xi kicked off last week, with the main issues likely to be centered on North Korea and trade agreements. The outcome of the meeting will set the political agenda for the two largest economies for at least the next four years. Trump may try to convince Xi to tighten economic sanctions on North Korea. China is by far North Korea's largest trading partner. However, the two countries have very different views of their preferred outcome.

Dovish Reserve Bank of Australia

The Reserve Bank of Australia held rates at 1.5% this week. The accompanying statement was slightly dovish, with the central bank noting the softening of labor market indicators and the modest pace of employment growth. The RBA also mentioned the desire of the board to reinforce strong lending standards in the country. These measures are likely to slow the housing sector and potentially delay the date of the first rate hike.

On the economic front, Australia's trade surplus came larger than expected in February, rebounding to a near record AUD 3.6 billion offsetting the surprising drop to AUD1.5bn in January. Total export values surged by a 30% on a yearly basis, driven by higher commodity prices. It is important to note that the large percentage in commodities prices from a year ago were the main driver of such an increase.

Kuwait

Kuwaiti Dinar at 0.30525

The USDKWD opened at 0.30525 on Sunday morning.

Rates – 27th November, 2016

	Previous Week Levels				This Week's Expected Range		3-Month
Currencies	Open	Low	High	Close	Minimum	Maximum	Forward
EUR	1.0658	1.0578	1.0689	1.0588	1.0360	1.0660	1.0650
GBP	1.2539	1.2361	1.2555	1.2372	1.2195	1.2450	1.2410
JPY	111.38	110.11	111.58	111.05	109.10	112.60	110.65
CHF	1.0021	1.0005	1.0096	1.0088	0.9960	1.0300	1.0035