International scene

Brexit and politics dominate markets for now; Fed turns it down a notch

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This year, the usual summer lull is expected to be anything but. Major events are upon us: starting with the aftermath of the Brexit referendum and going into the major parties' nominating conventions for the US presidential election, in what is expected to be an unconventional US election year. The economic reports remain "as expected" but tentative enough to keep the Fed erring on the side of "less" (tightening) action, while the ECB and the BOJ are still ready to do "whatever is necessary" on the easing side. All the while, central bank credibility is getting strained on several fronts: communication and resolve for the Fed, policy effectiveness for the ECB and BOJ.

The financial world remains focused on politics and on the major central banks, who for quite some time have assumed alone the mantle of helping the economies. Fiscal policies and/or structural reforms are still nowhere to be seen. Japan has (wisely) just postponed a move to raise taxes in 2017, while France is meeting tremendous and sometimes violent resistance to a relatively moderate labor reform.

True to form, the IMF revised down its outlook for 2016 by another 0.2% in April, to 3.2%, which if it holds would leave growth unchanged from 2015. The major change or surprise so far this year has been the change of heart regarding Federal Reserve policy. Not only did perceptions go from the unrealistic "4 hikes" in December 2015 to "2 hikes" for this year, but now the latter has been reduced to "perhaps only one". Furthermore, the timing of any hike has been pushed for later in the year. This new Fed view, by the markets, is of course largely responsible for US interest rates moving lower on the year, as well as for a lower dollar. The latter is still down 4% to the euro by midyear, and more than 12% to the Japanese yen (ytd).

Back in May, US economic data appeared strong enough to justify the second Fed hike of this cycle, though that may now have changed. Some firming of wage and price inflation, higher oil prices, good retail sales and home sales reports were all pointing in the right direction. However many analyst, we included, thought the Brexit vote on 23 June and surrounding uncertainty would keep the Fed at bay until a "better timing", i.e. after the U.K. referendum. That scenario was somewhat shaken by a very weak employment report for May.

The May report showed a gain of only 38K new jobs, versus a 12-month average of 215K. This gain was held back by a strike in the telecom sector, which subtracted about 36K jobs (these will return in the June report). Nonetheless, the jobs report was weak enough, along with downward revision to March and April, to give the Fed pause. Note also that a decline in the unemployment rate to 4.7% (lowest since 2007), while strong on the surface, occurred for the "wrong" reasons: a large decline in the labor force. That report raised enough question marks to postpone Fed action, though the Fed did mention, of course, that one report would not be enough to change the overall course of policy. The Fed Chair Janet Yellen quickly adjusted her language "dovishly", and the

June meeting "dot-plots" showed 11 out of 17 FOMC members expecting "2 or more" hikes this year, down from 16 members in April. I.e. the odds of only "one hike" for this year are definitely up.

The major economies appear to be growing in line with expectations, while deflation continues to be a concern. In 1Q16, China grew 6.7%, the US 1.9%, and the EU 1/7% (all y/y). In Japan, however, real GDP was "flat" y/y; this was one of the factors prompting the government to postpone its planned sales tax hike from 2017 to 2019. Inflation remains below target for all major economies and too close to zero in many cases, thus still keeping the ECB and the BOJ on the verge of further "ease" action, quantitative and other. 10-year rates are negative in Japan, and teetering near zero for German Bunds. These low rates and the less aggressive Fed are keeping US rates in check, the 10-year US note hit a 4-year low near 1.6%.

As mentioned earlier, this "as expected" economic environment has all eyes focused on Brexit. Our best guess is that the EU and the UK will need to sort a few things out regardless of the vote outcome. Obviously, volatility and impact would be much larger in the case of "exit". We contend that, in a calm political environment, the UK should be able to renegotiate reasonable arrangements with the EU over a longer period of time and with minimal or acceptable disruption for the economies of all concerned. However, there is a risk of contentious politics and of spillovers into other countries, especially where separatists and Eurosceptics are gaining ground. In that case, the volatility and economic impact could be more severe and longer lasting.

For the GCC economies, we continue to expect moderate GDP growth in 2016, as governments remain committed in large part to government spending. The fiscal adjustments should be gradual, as policy makers are keen on keeping growth smooth and ongoing. Non-oil GDP growth should post 4-4.5% for the region. More particularly, KSA announced details for the first years of its 2030 transformation plan that entails reform, private jobs creation, and privatization. All GCC countries are still gearing up to issue sovereign debt in order to finance their deficits. Debt issuance is pressuring liquidity but is also creating an opportunity for the region to further open up and develop its fixed-income markets.

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