بنك أبوظبي التجاري
ADCB

Volatility reigns, negative US rates discussed

End of week rebound in US markets aside, the global rout in risk assets continued last week. Bulls expecting Fed Chair Janet Yellen to talk down the prospect of further increases in interest rates during her testimonies to Congress and the Senate were left disappointed. The most interesting thing to come out of the testimonies was the number of questions the Fed chair had to field on the prospect of introducing negative interest rates in the US. Mrs Yellen indicated that the Fed is studying the feasibility of such a move, but stopped well short of saying it was a viable option. However, the mere fact that negative interest rates in the US are being discussed speaks volumes about the strength of underlying fundamentals. It is not a development which investors should cheer in our view. Indeed, looking at the sharp sell-off in banks last week suggests they are not. Sweden's experience, which has had negative interest rates for over a year now (and last week cut even deeper into negative territory) serves as a powerful reminder (if we needed any further) of how close we are to the limits of monetary policy.

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This year's equity market sell-off still small in the grand scheme

Investors and financial market analysts alike are often guilty of short-termism, focussing too much on near-term developments thereby losing sight of the bigger picture. However, if we take a step back we will see that the S&P 500 has risen 220% since the bottom in 2009 when it reached 666. After such a long and strong run it is normal to have a correction, not a 10% move lower like we have seen fairly regularly during the past 7 years, but a 20-25% move lower before equities look fairly valued again. If this is right, then we are roughly half way through this process. Although other markets, especially European, Japanese and Chinese equities have corrected much more than US equities, we believe they are unlikely to be able to decouple in this very broad, macro driven sell-off. We have written in the past that investors should expect high volatility as policy makers around the world intervene leading to sharp, short-term rallies. We expect this to continue and caution against buying into these rallies. Ultimately, however, the correction is a path to a better entry point for equities. However, in our view it remains too early to position for this and we continue to prefer US Treasuries as the best risk hedge.

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Past week global markets' performance

Index Snapshot (World Indices)

Index	Latest	Weekly Chg %	YTD %
S&P 500	1,864.8	-0.8	-8.8
Dow Jones	15,973.8	-1.4	-8.3
Nasdaq	4,337.5	-0.6	-13.4
DAX	8,967.5	-3.4	-16.5
Nikkei 225	14,952.6	-11.1	-21.4
FTSE 100	5,707.6	-2.4	-8.6
Sensex	22,986.1	-6.6	-12.0
Hang Seng	18319.6	-5.0	-16.4
Regional Markets (Sunday to Thursday)			
ADX	4095.2	-1.7	-4.9
DFM	3039.9	-2.5	-3.5
Tadawul	5660.9	-5.2	-18.1
DSM	9485.9	-2.0	-9.0
MSM30	5359.13	2.2	-0.9
BHSE	1166.4	-0.9	-4.1
KWSE	5139.1	-1.3	-8.5
MSCI			
MSCI World	1,486.5	-2.5	-10.6
MSCI EM	711.2	-3.8	-10.4

Global Commodities, Currencies and Rates

Commodity	Latest	Weekly Chg %	YTD %
ICE Brent USD/bbl	33.4	-2.1	-10.5
Nymex WTI USD/bbl	29.4	-4.7	-20.5
OPEC Baskt USD/bbl	25.2	-14.0	-19.4
Gold 100 oz USD/t oz	1238.0	5.5	16.7
Platinum USD/t oz	955.4	4.8	7.2
Copper USD/MT	4488.5	-3.9	-4.5
Alluminium	1498.5	0.2	-0.5
Currencies			
EUR	1.1256	0.9	3.6
GBP	1.4503	0.0	-1.6
JPY	113.25	-3.1	6.2
CHF	0.9771	-1.4	2.6
Rates			
USD Libor 3m	0.6182	-0.2	0.9
USD Libor 12m	1.1156	-1.8	-5.3
UAE Eibor 3m	1.0299	-1.4	-2.4
UAE Eibor 12m	1.5341	-0.3	4.0
US 3m Bills	0.2798	-3.5	72.0
US 10yr Treasury	1.7481	-4.8	-23.0

Please refer to the disclaimer at the end of this publication

Negative rates are the last roll of the dice

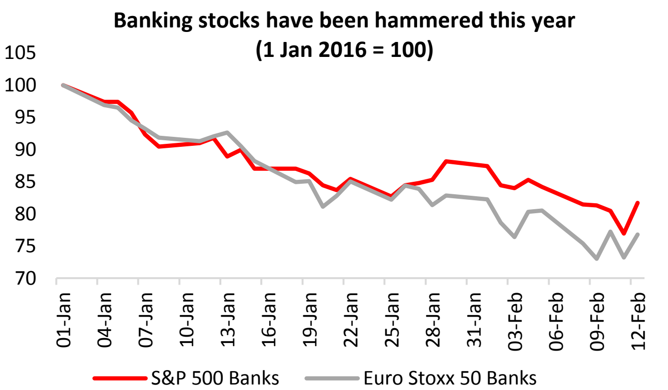
Two months after lift-off, talk moves to negative rates

Data out of the US on the whole has been disappointing. It is fair to say that since the Federal Reserve raised interest rates mid-December the chance of a recession in the US has increased. The data tells us that we are already in a manufacturing recession in the US, which although not huge share of GDP, has been a good leading indicator for services. The question has been will manufacturing pull services down or will services pull manufacturing up? Recently services have also started turning down, albeit remaining in expansionary territory. This therefore remains one of the most important indicators to watch in the short term.

Looking at the bigger picture, statistically we should now be closer to the next US recession than we are to the previous one while in all US recessions since the 1970s the Fed has cut interest rates by a minimum of 500bps. This time round there is no such buffer. It can therefore not come as a huge surprise that the recent softening of economic data going has gone hand in hand with talk of negative interest rates in the US. The only surprise is how soon after the Fed's "lift-off" this has come.

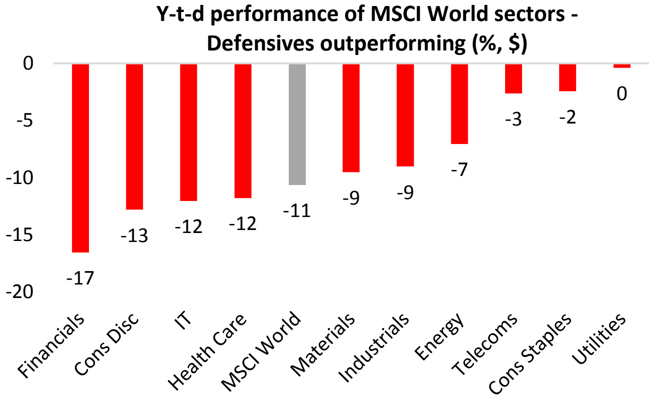
Banks the focal point for concern over negative rates

It was interesting to see market reaction last week to rumours of potential negative rates in the US or even more negative rates in Europe. Banking stocks, which would be most sensitive to negative interest rates continued their slide before recouping some loses on Friday. In aggregate US and European banks are down 18% and 23% respectively in the first 10 weeks of the year (in US dollars).



Source: Thomson Reuters Datastream

What can we read into this? Firstly, it is important to note that we do not believe that there is anything systemically wrong with banks in the developed world and so do not believe that a 2008 style banking sector collapse is on the cards. What is happening is that investors are beginning to assign a greater probability to a more severe economic slowdown in the US (as well as globally). Further economic slowdown carries with it heightened prospects of negative rates and lower bond yields. This will translate into a compression of banks' net interest margins. This we believe is the main factor behind the sell-off in the banks. Side issues are banks' exposure to the weakness and debt in the energy sector as well as the fact that banks are large cap, highly liquid stocks which are easy to sell when investors want to exit positions.



Source: Thomson Reuters Datastream

How negative rates could backfire

So far, major central banks appear on a clear course. Step 1; cut rates to zero, Step 2; introduce QE, Step 3; cut rates into negative territory. Sweden has had negative interest rates for over a year already and recently cut rates further into negative territory (by 15bps) to -0.5%. So far the policy has failed in its main goal of generating inflation. Headline inflation in Sweden remains around zero (0.1% currently), and although economic growth in the country is strong, financial instability is growing in the form of rampant house prices and strong credit growth in an already highly indebted society.

The Swedish experience is not unique, negative interest rates have not had the desired impact in other economies either, for example Switzerland and the Eurozone. So why then pursue them? It appears to us to be the last roll of the dice for most central banks. If unprecedented levels of QE have not worked in the background of policy rates having been cut to zero, why then should a relatively small cut into negative territory be the game changer? In all likelihood central bankers feel that they have to appear to have tried everything, and so it is more of a signalling effect.

The experiment could also backfire. So far in countries where negative rates prevail the banks have borne the costs, at some point however, it is feasible that the costs are passed on to the consumer. This would severely hamper and chances of an economic recovery and likely lead to inflation expectations to falling further. This is a development which needs to be closely monitored in our view.

Summary market outlook

Global Yields	10 year US Treasury yields closed lower on the weekly basis despite a more than 20bps recovery from lows. European sovereign yields were largely stable last week but could see some up-tick as CDS spreads moved up.	
Stress and Risk Indicators	The VIX index closed higher despite some pull back towards the end of the week. Sovereign CDS spreads, especially for India (among Asian markets) ticked-up due to the sell-off in global risk assets. We expect these risk indicators to remain elevated as the global risk-off environment continues.	
Precious Metals	The gold price continued its upward momentum last week. A further spike cannot be ruled out given current global risk aversion. Long-term we remain cautious on gold, as global pressures are by and large deflationary.	
Local Equity Markets	It was a volatile week for GCC equity markets last week, tracking volatility in the oil price. We remain cautious until we see signs of stabilization in oil prices.	
Global Equity Markets	Despite a rebound towards the end of the last week, global equity markets closed firmly in the red over the course of the week. Given our cautious outlook on the global cycle we remain underweight global equities.	
Energy	The oil price was very volatile, rebounding very sharply on Friday but ultimately still closing out the week with a decline. The widening gap between the two benchmarks (Brent and WTI) signals continuing volatility.	
Industrial Metals	Industrial metals prices were relatively stable during the week, and continue to lack an identifiable catalyst in our view.	
Currencies	**Commentary**	**Critical levels**
EURUSD	The euro remained largely in stronger territory for the most part of last week. However, we reiterate that the currency is close to its peak. Therefore, we see some possibility of a reversal in the near term. (Note that stronger spike in risk-off sentiment will strengthen the currency.)	R2 - 1.1529 R1 - 1.1392 S1 - 1.1103 S2 - 1.0951
GBPUSD	The pound closed flat last week after trading in a narrow range. However, the ongoing referendum issue (with the possibility that the UK might leave the EU) will keep the currency volatile.	R2 - 1.4704 R1 - 1.4603 S1 - 1.4377 S2 - 1.4252
USDJPY	The rise in the global risk-off environment caused strength in yen despite the BoJ's recent action. Contrary to our expectations, no resistance kicked-in and the currency touched its strongest level since late 2014. We believe that the BoJ will not be comfortable with such strength in the yen amid weakening economic activity.	R2 – 120.46 R1 – 116.86 S1 – 110.32 S2 – 107.38

Forthcoming important economic data

United States

	Indicator	Period	Expected	Prior	Comments
02/16/2016	NAHB Housing Market Index	Feb	60	60	A good set of important releases from housing sector to industrial sector to inflation will be looked at by the market.
02/17/2016	Housing Starts	Jan	1175k	1149k	
02/17/2016	Building Permits	Jan	1200k	1204k	
02/17/2016	Industrial Production MoM	Jan	0.4%	-0.4%	
02/19/2016	Leading Index	Jan	-0.2%	-0.2%	
02/19/2016	CPI Core YoY	Jan	2.1%	2.1%	
02/19/2016	Real Avg Weekly Earnings YoY	Jan	Na	1.6%	

Japan

	Indicator	Period	Expected	Prior	Comments
02/15/2016	GDP Annualized QoQ	4Q P	-0.8%	1.0%	Fourth quarter GDP is again expected to decline while trade data for the first month of the current year is also expected to be in negative territory.
02/15/2016	Industrial Production MoM	Dec F	NA	-1.4%	
02/15/2016	Tertiary Industry Index MoM	Dec	-0.1%	-0.8%	
02/17/2016	Machine Orders MoM	Dec	4.7%	-14.4%	
02/18/2016	Exports YoY	Jan	-11%	-8.0%	
02/18/2016	Imports YoY	Jan	-15.9%	-18.0%	
02/19/2016	All Industry Activity Index MoM	Dec	-0.3%	-1.0%	

Eurozone

	Indicator	Period	Expected	Prior	Comments
02/15/2016	ZEW Survey Expectations	Feb	NA	22.7	Not really very important data this week from the Eurozone.
02/19/2016	Consumer Confidence	Feb A	-6.6	-6.3	
02/16/2016	ZEW Current Situation (GE)	Feb	55.0	59.7	
02/16/2016	ZEW Survey Expectations (GE)	Feb	0.0	10.2	

China and India

	Indicators	Period	Expected	Prior	Comments
This week	Money Supply M2 YoY (CH)	Jan	13.5%	13.3%	Market will look at the external trade data and inflation from China and India.
This week	New Yuan Loans CNY (CH)	Jan	1900B	598B	
02/15/2016	Exports YoY (CH)	Jan	-1.8%	-1.4%	
02/15/2016	Imports YoY (CH)	Jan	-3.6%	2.3%	
02/15/2016	Trade Balance (CH)	Jan	$60.6B	$60.1B	
02/18/2016	CPI YoY (CH)	Jan	1.9%	1.6%	
This week	Exports YoY (IN)	Jan	NA	-14.8%	
This week	Imports YoY (IN)	Jan	NA	-3.9%	
02/15/2016	Wholesale Prices YoY (IN)	Jan	-0.13%	-0.73%	

Sources

All information in this report has been obtained from the following sources except where indicated otherwise:

1. Bloomberg
2. Wall Street Journal
3. RTTNews
4. Reuters
5. Gulfbase
6. Zawya

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