The Weekly Market View

May 23 2016

بنك أبوظبي التجاري ADCB

Fed addresses investor complacency over rate hikes

Developed equity markets finished the week mixed, but initially came under pressure as FOMC minutes from the Fed's April meeting showed that committee members will seriously consider raising interest rates in June if economic data continues to improve. Markets then staged a relief rally on Friday which was altogether not unexpected given the third Friday of every month is option expiry and typically sees equities well supported. The swings in equities meant that volatility as measured by the VIX ticked up. The unexpectedly hawkish Fed minutes resulted in a rise in Federal funds futures which went from indicating around a 10% probability of a June rate hike to a 30% probability. This weighed on treasuries, the 10-year yield rising 13bps while gold had one of its worst weeks of the year falling nearly 2%. As discussed last week already, a hawkish Fed is bad for EM assets, correspondingly EM currencies and equities were among the biggest losers last week. EM equities are down 6.5% in May and are back in the red for the year.

The start of the year risks repeating itself as the Fed shifts again

Minutes from April's Federal Reserve meeting show that committee members would like to raise interest rates at the June or July meeting if conditions allow. This came as a shock to investors which had gotten used to a dovish Fed. The Fed is now clearly telling investors that every meeting is a 'live' meeting in which rates can be raised and marks a departure from the dovish forward guidance which markets have enjoyed in recent months. While we think the probability of a June hike is extremely low given the Fed will not yet know the outcome of the Brexit referendum on June 23rd, the Fed has now clearly decided to go down a more hawkish route. This has huge investment implications as it means market conditions could soon start to resemble those of the end of 2015/beginning 2016 again. This environment, characterized by a strengthening US dollar is unfavourable for risk assets, especially for Emerging Markets. Given the Fed's change of tack, Investors will pay even greater attention to US economic data, starting with the second reading of Q1 US GDP on Friday.

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Past week global markets' performance

Index Snapshot (World Indices)			
Index	**Latest**	**Weekly Chg %**	**YTD %**
S&P 500	2,052.3	0.3	0.4
Dow Jones	17,500.9	-0.2	0.4
Nasdaq	4,769.6	1.1	-4.8
DAX	9,916.0	-0.4	-7.7
Nikkei 225	16,736.4	2.0	-12.1
FTSE 100	6,156.3	0.3	-1.4
Sensex	25,301.9	-0.7	-3.1
Hang Seng	19852.2	0.7	-9.4
Regional Markets (Sunday to Thursday)			
ADX	4229.4	-3.5	-1.8
DFM	3224.2	-3.4	2.3
Tadawul	6695.3	0.0	-3.1
DSM	9814.0	-1.3	-5.9
MSM30	5930.98	-0.6	9.7
BHSE	1102.6	-0.8	-9.3
KWSE	5325.4	-1.3	-5.2
MSCI			
MSCI World	1,639.9	0.2	-1.4
MSCI EM	785.3	-1.4	-1.1

Global Commodities, Currencies and Rates			
Commodity	**Latest**	**Weekly Chg %**	**YTD %**
ICE Brent USD/bbl	48.7	1.9	30.7
Nymex WTI USD/bbl	48.4	3.3	30.7
OPEC Baskt* USD/bbl	43.8	1.3	40.2
Gold 100 oz USD/t oz	1252.0	-1.7	18.0
Platinum USD/t oz	1022.7	-2.8	14.7
Copper USD/MT	4630.5	-0.6	-1.5
Alluminium	1540	1.5	2.3
Currencies			
EUR	1.1224	-0.8	3.3
GBP	1.4502	1.0	-1.6
JPY	110.15	1.4	9.1
CHF	0.9903	1.5	1.2
Rates			
USD Libor 3m	0.6613	5.4	7.9
USD Libor 12m	1.3020	5.9	10.5
UAE Eibor 3m	1.0947	2.0	3.8
UAE Eibor 12m	1.6693	2.2	13.2
US 3m Bills	0.3052	15.4	87.6
US 10yr Treasury	1.8384	8.1	-19.0

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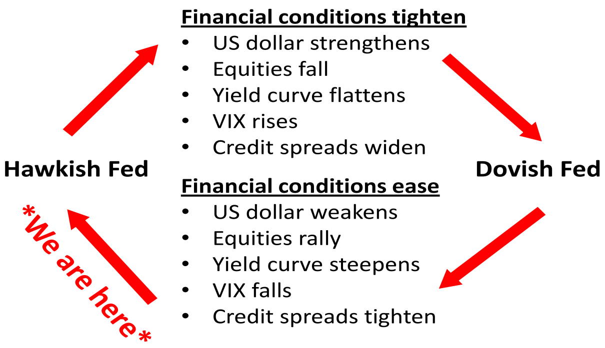
بنك أبوظبي التجاري ADCB

From hawks to doves back to hawks, big implications of the Fed's latest change in rhetoric

Going full circle?

December 2015 through to early February of this year were difficult months for financial markets. Investors speculated whether or not the Fed had made a mistake in hiking interest rates in its December meeting. Recall that the minutes of the meeting showed the dot plots, the median projections of expected interest rates by FOMC members, projecting four further hikes in 2016. At the same time concerns also resurfaced over the sustainability of China's FX regime as well as worries over global growth. These issues are not isolated, but interlinked by the US dollar. At the time, a hawkish Fed seemingly determined to hike interest rates caused a strengthening of the US dollar. This created immense discomfort in the EM world, especially China whose currencies is still largely managed against the greenback.

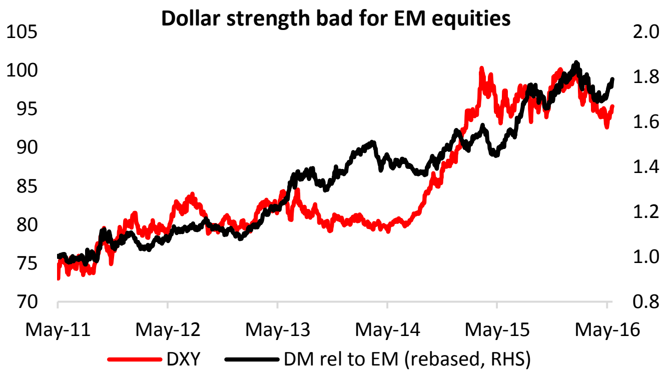
Fed policy Loop



Source: BCA Research, ADCB

Fast forward a few months and the tables had turned. The Fed in its March meeting turned unexpectedly dovish. The dot plots were revised to signal just two interest rate hikes in 2016, rather than four. As a result, the dollar weakened sharply, the benefits of which rapidly spread to all risk assets. Although a weaker dollar (and thus stronger Euro and Yen) is unhelpful for European and Japanese equities, markets in Europe and Japan rallied hard regardless, boosted by diminishing fears over a global recession while still enjoying ultra-loose domestic monetary policy. Emerging market equities enjoyed a double tailwind as the weaker dollar catapulted commodity prices, especially oil higher while strengthening EM currencies decreased the pressure on inflation expectations while also making dollar-denominated debt more easily serviceable. A very favourable mix for heavily oversold EM assets. The chart below shows the DXY (an index of the dollar vs. a basket of foreign currencies) against developed world equities relative to emerging equities. When the black line is going up, it means developed equities are outperforming emerging ones.

The question has been how long could this last. We have been arguing for some time in our weekly reports that a weak dollar and dovish Fed is ultimately unsustainable giving the relative strength of the US economic cycle vis a vis other major countries and regions. Whether or not the past week marked the definitive inflection point in the Fed's transition to a more hawkish bias only time will tell. What is clear, however, is that the Federal Reserve remains determined to hike interest rates further this year. With market conditions having stabilized and fears over global growth having ebbed away, the Fed will increasingly want to prepare investors for the next rate increase. As these expectations build, the pressure on risks assets that we saw at the start of the year will re-emerge (see the Fed policy loop graphic on the left). While it seems to us unlikely that the Fed will raise rates in its June meeting given that it will not yet know the outcome of the UK's Brexit referendum, equally holding rates steady in June is unlikely to spark another risk rally. We believe the purpose of the April FOMC minutes was not to prepare investors for hike at the next meeting, but rather to address investor complacency about potential rate hikes. The Fed now needs to sound more hawkish so that when it does raise rates again, it will not come as a huge surprise to the market.



Source: BCA Research, ADCB

Sell in May and go away?

With Q1 earnings season now more or less finished, investors will be searching for the next catalyst. If what we have written above is correct, then investors can no longer count of Fed chair Yellen talking up the markets. Other than policy support there seems to be no easily identifiable catalyst on the horizon in the near-term. Rather, there are plenty of risks. US corporate earnings have contracted for a fourth consecutive quarter, valuations are expensive and political uncertainty in the form of the Brexit referendum and US elections will likely act as a drag on confidence. In fact, we have now entered the period of the year during which equities have historically struggled. The old mantra "sell in May and go away" is so far holding, as it did last year too.

Summary market outlook

Bonds	
Global Yields	10-year US Treasury yields moved up sharply to 1.83% from 1.70% last week. This happened in response to much more hawkish than expected minutes from the April FOMC meeting which suggested the probability of a June or July rate increase in the US is much higher than what the market was anticipating.
Stress and Risk Indicators	US equity markets were pulled in different directions, firstly the FOMC minutes saw a sharp drop in equities, only for markets to rebound heading into monthly option expiry at the close on Friday. The result was that the VIX index rose.

Equity Markets	
Local Equity Markets	The strength in oil prices last week was not reflected in local equity markets. Oil rose and local equities fell, in the case of UAE markets sharply. A more hawkish Fed means a stronger dollar, this is bad for local equities. Especially given that local markets import US monetary policy and will likely raise rates if and when the Federal Reserve raises rates.
Global Equity Markets	Global equities were flat over the course of the week, with EM underperforming DM. The prospect of a more hawkish federal reserve is extremely negative for Emerging Markets. We continue to believe that equities are mispriced given weak top-down and bottom-up fundamentals.

Commodities	
Precious Metals	Gold had one of its worst weeks of the year, falling almost 2% during the week but remained a fraction above the recent $1250 support. The metal has made strong gains this year, albeit virtually all the gains came in Q1. Risks to the global economy remain aplenty, this will continue to underpin precious metals in the near term. However, long-term we remain cautious on gold, as global pressures are by and large deflationary.
Energy	Oil prices enjoyed a rebound of between 3-7% as the International Energy Agency said global crude inventories will experience a “dramatic reduction” in the second half of the year on the back of strong demand and falling supplies.
Industrial Metals	Industrial metals showed no clear trend during the week. Aluminium prices rose but copper fell. Overall we expect downward pressure on industrial metals to remain with us for the foreseeable future on the back of concerns over the global, and especially China’s economic growth.

Currencies								
EURUSD	The change in the US dollar’s direction in recent weeks (from strong to weakening) was reinforced by the hawkish Fed minutes from the April FOMC minutes. The euro weakened 0.8% against the dollar, we believe it is likely to move lower still in the coming weeks and months.							
Critical levels	R2	1.1420	R1	1.1322	S1	1.1153	S2	1.1082
GBPUSD	The British pound weakened 1% against the dollar last week, driven by Fed policy minutes. The currency pair is likely to be volatile with a downward bias (GBP) due to the overhang of “Brexit” referendum in just one month’s time.							
Critical levels	R2	1.4829	R1	1.4666	S1	1.4336	S2	1.4169
USDJPY	The Japanese yen weakened by 1.4% for a second consecutive week. Just as it did last week, this buoyed Japanese equities which had come under severe pressure due to yen strength during previous weeks. The problem for the yen is that huge stimulus has weakened it greatly already. The scope for further stimulus is now very low which suggests some of this weakness should unwind. On the flipside, Japanese macro fundamentals are extremely weak.							
Critical levels	R2	111.86	R1	111.00	S1	108.88	S2	107.62

Forthcoming important economic data

United States

	Indicator	Period	Expected	Prior	Comments
5/23/2016	Markit US Manufacturing PMI	May P	51.0	50.8	PMI data, core PCE and the second reading of Q1 GDP will likely be the focus for the market this week in the US.
5/24/2016	New Home Sales	Apr	521k	511k	
5/25/2016	Markit US Services PMI	May P	53	52.8	
5/25/2016	Markit US Composite PMI	May P	--	52.4	
5/26/2016	Durable Goods Orders	Apr P	0.40%	0.80%	
5/26/2016	Pending Home Sales MoM	Apr	0.70%	1.40%	
5/26/2016	Pending Home Sales NSA YoY	Apr	0.20%	2.90%	
5/27/2016	GDP Annualized QoQ	1Q S	0.90%	0.50%	
5/27/2016	Personal Consumption	1Q S	2.10%	1.90%	
5/27/2016	GDP Price Index	1Q S	0.70%	0.70%	
5/27/2016	Core PCE QoQ	1Q S	2.10%	2.10%	
5/27/2016	U. of Mich. Sentiment	May F	95.5	95.8	

Japan

	Indicator	Period	Expected	Prior	Comments
5/22/2016	Trade Balance	Apr	¥540.0b	¥755.0b	PMI, retail sales and inflation will give an insight into the strength (or weakness) of the Japanese cycle.
5/22/2016	Exports YoY	Apr	-9.9	-6.8	
5/22/2016	Imports YoY	Apr	-19.2	-14.9	
5/22/2016	Nikkei Japan PMI Mfg	May P	--	48.2	
5/26/2016	Natl CPI YoY	Apr	-0.40%	-0.10%	
5/26/2016	Natl CPI Ex Fresh Food YoY	Apr	-0.40%	-0.30%	
5/26/2016	Natl CPI Ex Food, Energy YoY	Apr	0.60%	0.70%	
5/29/2016	Retail Sales MoM	Apr	--	1.40%	

Eurozone

	Indicator	Period	Expected	Prior	Comments
5/23/2016	Markit Eurozone Manufacturing PMI	May P	51.9	51.7	PMI data across the Eurozone will be most closely watch along with the German IFO survey release.
5/23/2016	Markit Eurozone Services PMI	May P	53.2	53.1	
5/23/2016	Markit Eurozone Composite PMI	May P	53.2	53	
5/23/2016	Consumer Confidence	May A	-9	-9.3	
5/24/2016	ZEW Survey Expectations	May	12	11.2	
5/25/2016	IFO Business Climate	May	106.8	106.6	
5/25/2016	IFO Current Assessment	May	113.3	113.2	
5/25/2016	IFO Expectations	May	100.8	100.4	

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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