The Weekly Market View

December 19 2016

Markets take Fed rate hike in their stride

After a year of sitting on their hands, the Fed raised interest rates for only the second time since the global financial crisis, by 25 basis points. Financial markets had assigned a 100% probability to the hike, as such it was a non-event. More interesting was the more hawkish than expected shift in the Fed's outlook. The famous dots now suggest three hikes in 2017 vs. two previously. This suggests that FOMC members, in the back of their minds are factoring in some impact of a Donald Trump Presidency. The impact of the "additional" rate hike was not enough to push equities down across the board, however, US equities did underperform their European and Japanese counterparts which were boosted by further dollar strength. Emerging Markets were inevitably hurt while Treasuries rallied further and precious metals suffered.

Major central banks' divergence leads to further dollar strength

Less than two weeks ago the ECB's monetary policy committee decided to extend its bond purchase program by a further 9 months, albeit they will purchase bonds at a slower pace (€60bn a month instead of €80bn). This has been interpreted by the market as more dovish than expected. The Fed on the hand, thanks to an upward shift in the dots (the expected appropriate level of Fed funds rate) surprised markets on the hawkish side. The outcome of this divergence has been higher Treasury yields and further dollar strength. Both the dollar and Treasuries have moved a long way since the US election on November 8th, and whilst it seems reasonable to expect a pause, we do not expect a major reversal of this trend in the coming weeks. This means that EM assets are likely to remain under pressure.

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Past week global markets' performance

Index Snapshot (World Indices)

Index	Latest	Weekly Chg %	YTD %
S&P 500	2,258.1	-0.1	10.5
Dow Jones	19,843.4	0.4	13.9
Nasdaq	5,437.2	-0.1	8.6
DAX	11,404.0	1.8	6.2
Nikkei 225	19,401.2	2.1	1.9
FTSE 100	7,011.6	0.8	12.3
Sensex	26,489.6	-1.0	1.4
Hang Seng	22020.8	-3.3	0.5
Regional Markets (Sunday to Thursday)			
ADX	4463.0	-1.2	3.6
DFM	3554.5	-0.1	12.8
Tadawul	7090.9	-0.4	2.6
DSM	10224.1	1.7	-2.0
MSM30	5728.65	1.1	6.0
BHSE	1188.7	-0.3	-2.2
KWSE	5668.5	1.4	1.0
MSCI			
MSCI World	1,754.7	-0.3	5.5
MSCI EM	856.4	-2.4	7.8

Global Commodities, Currencies and Rates

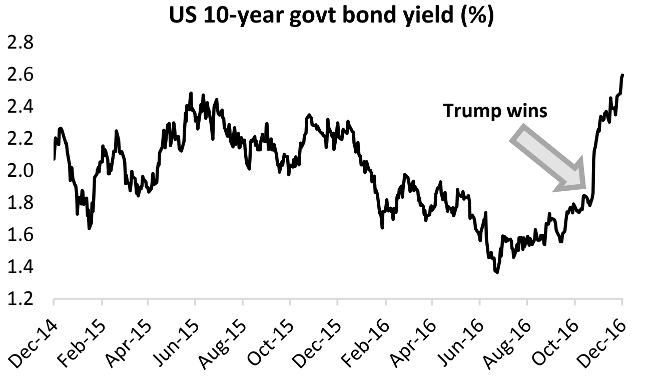
Commodity	Latest	Weekly Chg %	YTD %
ICE Brent USD/bbl	55.2	1.6	48.1
Nymex WTI USD/bbl	51.9	0.8	40.1
OPEC Baskt* USD/bbl	51.0	0.0	63.0
Gold 100 oz USD/t oz	1134.9	-2.2	7.0
Platinum USD/t oz	927.6	1.3	4.0
Copper USD/MT	5649.0	-3.0	20.1
Alluminium	1724.5	-1.8	14.5
Currencies			
EUR	1.0451	-1.0	-3.8
GBP	1.2496	-0.6	-15.2
JPY	117.93	2.3	1.9
CHF	1.0261	0.9	-2.3
Rates			
USD Libor 3m	0.9973	4.3	62.8
USD Libor 12m	1.6934	2.7	43.8
UAE Eibor 3m	1.3336	-2.1	26.4
UAE Eibor 12m	2.1903	2.4	48.5
US 3m Bills	0.4923	-7.6	202.6
US 10yr Treasury	2.5916	5.0	14.2

Please refer to the disclaimer at the end of this publication

What happens to bond yields and the dollar?

The 64 million dollar question

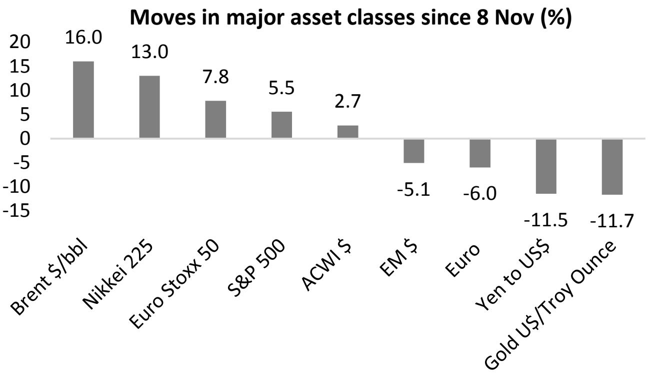
The main question investors will have for the coming year is what will happen to bond yields and the US dollar. The consensus is unclear, some market commentators calling for permanently higher US bond yields, others believing the post-election move higher is an overreaction which will reverse early in 2017. At ADCB Asset Management we are somewhere in the middle. We are not confident enough in Mr Trump's reflationary policies to position for significant further jump in yields, especially considering that 10-year Treasury yields have virtually doubled from their July lows. However, neither do we expect an imminent reversal in yields, given that Mr Trump's honeymoon period really only starts on January 20th meaning that markets will likely give him at least a few months from the date of taking office to gauge the impact his policies have on growth and interest rates. This means that benign equity market conditions for developed markets could persist for a little while longer.



Source: Thomson Reuters

Monetary policy underpins post-Trump trend

Since the election of Mr Trump as President of the United States, the dollar has strengthened substantially, US yields have surged, equities have rallied and gold has slumped.



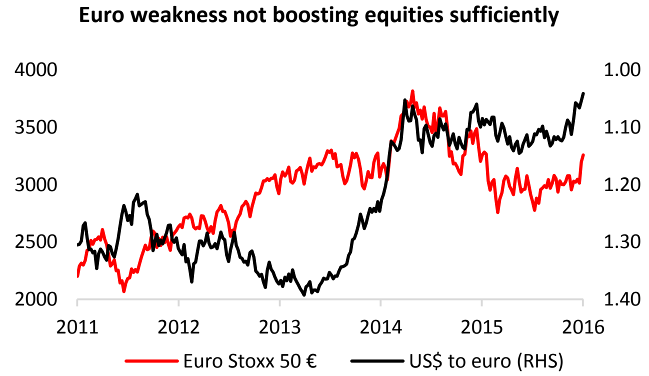
Source: Thomson Reuters

Rather than undermine these moves, recent Fed and ECB actions have reinforced them. This can continue for a little while longer, however, ultimately higher US yields and continued dollar strength become self-limiting in that this tightens financial conditions in the US and risks choking off growth, meaning that monetary policy will need to be looser in order to compensate. For this reason we are also sceptical of the FOMC dots, believing that one or two rates hikes in 2017 are more likely than the three currently pencilled in.

What about Europe?

We have been underweight European equities since mid-January, during this time the region has underperformed US equities either by 13% ($) or by 9% (local currency). European equities look set to end the year on a strong note, however, we caution against extrapolating the performance over the past few weeks into Q1 2017 as there are still significant headwinds facing European equities.

The main problem is we do not see where earnings growth is going to come from. Just like in Japan, the corporate sector in Europe should in theory be enjoying stronger earnings on the back of a weak currency (the euro has averaged 1.11 vs. $ in the past two years compared with 1.33 in the two years before that). Nevertheless, earnings growth for each of those four years has been negative. More worrying perhaps, is that the consensus systematically over-estimates earnings year after year. 2017 earnings growth expectations are currently 13%, significantly up from the 0% in 2016. However, the last time European earnings growth was positive was in 2011.



Source: Thomson Reuters

Of course it is possible that earnings growth, thanks to a pick-up in the global business cycle does come through in Europe, however, valuations are stretched meaning that scope for disappointment is low. For investors wishing to play currency weakness as a driver of equity returns, we believe the link between Japanese equities and yen weakness is far stronger than between European equities and the euro.

Summary market outlook

Bonds	
Global Yields	Higher Fed funds rate trajectory envisaged by the Fed pushed 10yr yields higher. A hawkish Fed combined with Trump's expected fiscal reflationary policies are likely to keep the upward pressure on yields in the coming weeks.
Stress and Risk Indicators	Resilience in the US equity market fed through to lower levels in the VIX index. However, the index is close to its lower bound which suggests that it is unlikely to go down much further.
Equity Markets	
Local Equity Markets	GCC equity markets were mixed with major markets ending on the lower side. With the oil price stabilizing around USD55 per barrel, regional markets are also expected to move sideways in the near term. However, the strong dollar could create some pressure on the DFM. The next big catalyst will be government budgets in coming weeks.
Global Equity Markets	Global equity markets ended the week on slightly lower, especially EMs were affected by the strong dollar and higher Treasury yields. As the Fed sounded hawkish last week, the strength in the dollar is likely to sustain, which will continue putting pressure on EM equities in the very near term.

Commodities	
Precious Metals	Hawkish Fed and higher interest rate trajectory negatively affected the gold price. Strong dollar could still have downward pressure on the price. However, geopolitical risks and economic risks are here to stay, we therefore stick to our positive view on the gold price.
Energy	A production cut by OPEC boosted oil prices significantly. Near-term sentiment still seems positive for oil, however, we caution against positioning for a further significant rise from here.
Industrial Metals	Industrial metals declined last week, again due to the strong dollar. Moreover, we have doubts about the resilience of industrial metals since most of the demand comes from China and not the United States.

Currencies								
EURUSD	The euro lost against the greenback on the back of the more hawkish Fed. The strength in the broader dollar is likely to continue to exert the pressure on the euro in the very near term.							
Critical levels	R2	1.0799	R1	1.0625	S1	1.0322	S2	1.0193
GBPUSD	The broader strength in the dollar also pushed cable lower. We expect downward movement in the currency to continue in the near term, not least because of the political uncertainty in the UK.							
Critical levels	R2	1.2885	R1	1.2691	S1	1.2339	S2	1.2181
USDJPY	The yen continued its depreciating trend. The one sided movement in the currency has been sharp over the last few weeks, meaning that a pullback cannot be ruled out.							
Critical levels	R2	121.03	R1	119.48	S1	115.56	S2	113.19

Forthcoming important economic data

United States

Date	Indicator	Period	Expected	Prior	Comments
12/21/2016	Existing Home Sales	Nov	5.5m	5.6m	Housing market and consumer sentiment likely to be the focus of the market.
12/22/2016	GDP Annualized QoQ	3Q T	3.3%	3.2%	
12/22/2016	Durable Goods Orders	Nov P	-4.5%	4.6%	
12/22/2016	Personal spending	Nov	0.3%	0.3%	
12/22/2016	PCE Core YoY	Nov	1.7%	1.7%	
12/23/2016	New Home Sales	Nov	575k	563k	
12/23/2016	Univ. of Mich. Sentiment	Dec F	98.0	98.0	

Japan

Date	Indicator	Period	Expected	Prior	Comments
12/19/2016	Exports YoY	Nov	-2.3%	-10.3%	The BoJ's monetary policy meeting is the main event, albeit no change is expected.
12/20/2016	BoJ Policy Meeting	Dec	No change		
12/21/2016	All Industry Activity Index MoM	Oct	0.1%	0.2%	

Eurozone

Date	Indicator	Period	Expected	Prior	Comments
12/21/2016	Consumer Confidence	Dec A	-6.0	-6.1	Very little of note in Europe data-wise this week.
12/19/2016	IFO Business Climate (GE)	Dec	110.6	110.4	
12/20/2016	PPI YoY (GE)	Nov	-0.2%	-0.4%	

United Kingdom

Date	Indicator	Period	Expected	Prior	Comments
12/23/2016	GDP QoQ	3Q F	0.5%	0.5%	Industrial production and foreign trade data will be important for the market.
12/23/2016	Current Account Balance	3Q	-28.2B	-28.7B	

China and India

Date	Indicator	Period	Expected	Prior	Comments
					No major data.

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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