The Weekly Market View

March 13 2017

The market considers a rate hike this week a done deal

The last remaining hurdle to all but guarantee a rate hike at this week's Fed meeting has been convincingly cleared. Friday's data showed that the US economy added 235,000 new jobs in February, handsomely beating expectations. There was only good news in the labour data as the unemployment rate fell to 4.7%, the participation rate rose to 63% and wages grew 2.8% year-over-year. As a result the dollar rose against most currencies (apart from the euro) which weighed on emerging markets and commodity prices. Oil prices saw their steepest decline in a year on the back of US oil inventory data, rising US crude production and a growing rig count. Gold also continued its sell-off from the previous week, shedding another $30 (-2.4%), although the yellow metal remains up 5% year-to-date.

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Dollar strengthens again, but not against Draghi's euro

The strength of the latest US jobs report has led to rising probabilities that the Fed will deliver 3 or even 4 rate hikes this year. Not only this, but the debate is also shifting towards when the Fed might commence the process of reducing its sizeable balance sheet. These developments are dollar positive and following a short period of weakness in January, the stronger greenback theme is beginning to reassert itself. We expect this to continue as the reasons for US dollar strength are likely to be accompanied by growing risks in places such as the UK and the Eurozone. Pound sterling is coming under renewed pressure as the reality of triggering Article 50 beckons as early as this week. Also weighing on GBP is the growing likelihood of a second Scottish referendum on independence, possibly in 2018. In the Eurozone this week all eyes will be on elections in the Netherlands. Another underestimation in the polls, this time of support for the anti-establishment Freedom Party will likely put pressure on the euro as this will be viewed as a proxy for the more important upcoming French elections. For now, however, Mr Draghi's less downbeat assessment of economic prospects in Eurozone last week have helped the currency strengthen against the US dollar. However, the dollar train is regaining momentum, which does not bode well for emerging markets.

Past week global markets' performance

Index Snapshot (World Indices)

Index	Latest	Weekly Chg %	YTD %
S&P 500	2,372.6	-0.4	6.0
Dow Jones	20,903.0	-0.5	5.8
Nasdaq	5,861.7	-0.2	8.9
DAX	11,963.2	-0.5	4.2
Nikkei 225	19,604.6	0.7	2.6
FTSE 100	7,343.1	-0.4	2.8
Sensex	28,946.2	0.4	8.7
Hang Seng	23568.7	0.1	7.1
Regional Markets (Sunday to Thursday)			
ADX	4457.3	-3.0	-2.0
DFM	3520.2	-1.8	-0.3
Tadawul	6916.8	-1.4	-4.1
DSM	10467.2	-2.4	0.3
MSM30	5791.74	-0.4	0.2
BHSE	1353.6	0.9	10.9
KWSE	6711.2	-0.8	16.8
MSCI			
MSCI World	1,845.9	-0.2	5.4
MSCI EM	926.1	-0.5	7.4

Global Commodities, Currencies and Rates

Commodity	Latest	Weekly Chg %	YTD %
ICE Brent USD/bbl	51.4	-8.1	-9.6
Nymex WTI USD/bbl	48.5	-9.1	-9.7
Gold USD/t oz	1204.6	-2.4	5.0
Silver USD/t oz	17.0	-5.2	7.0
Platinum USD/t oz	942.5	-5.6	4.4
Copper USD/MT	5714.5	-3.3	3.9
Alluminium	1868	-0.9	10.3
Currencies			
EUR USD	1.0673	0.5	1.5
GBP USD	1.2167	-1.0	-1.4
USD JPY	114.79	0.7	1.9
CHF USD	1.0109	0.3	0.8
Rates			
USD Libor 3m	1.1212	1.8	12.4
USD Libor 12m	1.8184	0.6	7.9
UAE Eibor 3m	1.4087	1.0	-4.5
UAE Eibor 12m	2.0863	-2.3	-0.4
US 3m Bills	0.7414	6.6	49.1
US 10yr Treasury	2.5745	3.9	5.3

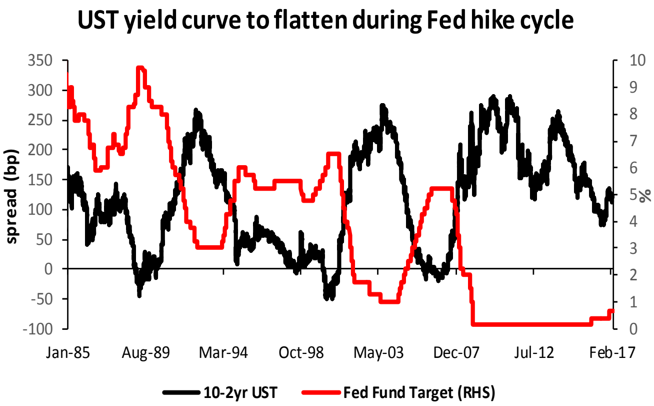
Please refer to the disclaimer at the end of this publication

March hike is a done deal

Long-end bonds sell-off appears overdone

Robust payrolls data has bolstered the case of the first Fed interest rate hike of the year at the upcoming FOMC meeting this week. As a result, government bond markets across the globe have been under selling pressure with 10yr US Treasury yields breaching the 2.6% level on an intraday basis. Surprisingly, the sell-off has been more concentrated in the back-end of the treasury curve. Steepening pressure on the 10-2yr segment of the US Treasury curve has been evident over the past two weeks in the build-up to the March FOMC rate setting meeting.

While the back-up in bond yields in response to the soaring probability of a rate hike is justifiable, the recent bear steepening trend appears excessive. The graph below indicates that the US treasury yield curve typically flattens during the rate hike cycle. This is because short-dated Treasury bonds are in general more sensitive to any re-pricing of rate hike expectations. Post the jump in probability of a March rate hike, Fed Fund futures indicate higher expectations of near-term tightening while the market's view on the long-run Fed fund rate has remained stable. However, front-end bond yields are not yet completely reflecting this near-term tightening. In fact, the implied yield of the Fed Fund Futures contract expiring in Jan 2019 has jumped more than the comparative 2yr Treasury bond yield since the March rate hike expectations started to build.

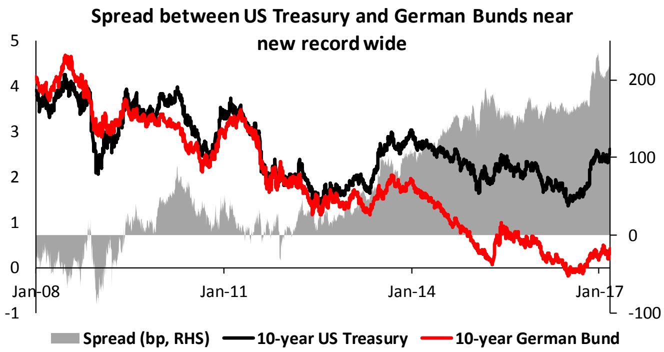


Source: Bloomberg

At the same time, the sell-off in 10yr US Treasuries appears overdone after bond yields breached the post US election trading range of 2.3-2.5%. Long-dated Treasuries mainly came under pressure in response to the reflation trade post the US election. While inflationary expectations have surged since the US election, they have remained fairly stable in recent weeks, contrary to the upward move seen in 10yr UST yields. The 5yr5yr forward inflation swap which best captures market pricing of future inflation expectations has hardly moved beyond its 2017 range, suggesting that markets are still sceptical about the inflation outlook. Although last year's deflation concerns are over, there is continued uncertainty over the implementation of reflationary fiscal policies promised by the new US administration. Given the lack of clarity regarding the fiscal policies along with political risk in Europe, we expect the 10-year US Treasury yields to remain contained within 2.3-2.5% range.

From hawkish Fed to hawkish ECB

The German bunds have been outperforming US Treasuries with the 10-year US Treasury-Bund spread having reached new record wide levels. Coupled with ECB asset purchases and negative interest rate policy, safe-haven flows on account of political uncertainty ahead of the elections has kept bund yields supressed compared to regional peers. However, beyond the upcoming election risks, it is important to evaluate the possibility of the ECB hitting the exit button later this year either through lifting the negative deposit rate which has been hurting banks' profitability or by further tapering asset purchases. Markets have clearly not priced in these possibilities which explains the upward correction in European bond yields post the ECB meeting where Mr Draghi acknowledged "less pronounced" downside risks to growth and revised up the ECB's inflation and growth forecasts. In such a scenario, German bund yields supported by the ECB buying could face upward pressure, particularly if economic data in Europe continues to positively surprise the market. As such, we could see the spread between the US Treasury and German bunds gradually narrow towards the end of this year if the hawkish bias shifts from the Fed to the ECB.



Source: Bloomberg

Summary market outlook

Bonds	
Global Yields	Global bonds remained under pressure, led by underperformance in US Treasuries. Robust economic data has raised the probability of a March rate hike, pushing the 10-year UST yield close to 2.6%. We do not expect any sharp spike in US treasury yields with markets fully pricing in a rate hike. In Europe, bond yields jumped in reaction to the ECB meeting which emphasized an improving economic outlook. However, policy uncertainty ahead of the heavy election calendar should limit upside in bond yields.
Stress and Risk Indicators	The VIX levels slightly jumped this week, yet remained subdued in spite of rising global political risks. We expect volatility to increase.
Equity Markets	
Local Equity Markets	GCC equity markets fell, tracking the decline in global equities. The sharp decline in oil prices also dampened sentiment in regional markets. We remain neutral on GCC equities given the potential for further dollar strength and limited upside in oil prices.
Global Equity Markets	Global equities ended the week on a weaker note with strong economic data raising the probability of rate hike at the upcoming FOMC meeting. Emerging markets underperformed the most. The S&P 500 slid by 0.4% as energy stocks underperformed with the sharp slump in oil prices. In contrast, Japanese equity markets rose higher mainly on account of yen weakness. Equity markets are likely to remain side-lined ahead of the FOMC rate decision this week.
Commodities	
Precious Metals	Gold prices declined for the second consecutive week, driven by the jump in expectations of Fed interest rate hike this week. We continue to stick to gold as a risk hedge against ongoing political and inflationary risks.
Energy	Oil posted weekly losses as continuous increase in US crude inventories dented the bullish outlook. We argue against any significant jump in oil prices as rising US rig counts and downbeat China demand should weigh on energy prices.
Industrial Metals	Industrial metals also suffered, tracking the decline in gold prices. We expect this trend to continue given the ongoing concerns on China demand.
Currencies	
EURUSD	The euro strengthened against the US dollar as the ECB acknowledged “less pronounced” downside risks to growth. We expect the euro to remain weak given the upcoming election calendar in key Eurozone countries.
Critical levels	R2 1.0775 · R1 1.0724 · S1 1.0598 · S2 1.0522
GBPUSD	The pound declined versus the dollar on disappointing UK consumer spending data. Pressure on pound is likely to remain ahead of the possible triggering of Article 50 this week.
Critical levels	R2 1.2214 · R1 1.2190 · S1 1.2142 · S2 1.2116
USDJPY	The Japanese yen weakened versus the dollar as better US economic data fuelled dollar demand. We expect this trend to continue given the potential for dollar strength.
Critical levels	R2 115.83 · R1 115.31 · S1 114.46 · S2 114.14

Forthcoming important economic data

United States

	Indicator	Period	Expected	Prior	Comments
3/15/2017	Empire Manufacturing	Mar	15	18.7	Market attention will be on the FOMC meeting where the central bank is expected to hike rates
3/15/2017	CPI YoY	Feb	2.70%	2.50%	
3/15/2017	CPI core YoY	Feb	2.20%	2.30%	
3/15/2017	Retail Sales Advance MoM	Feb	0.10%	0.40%	
3/15/2017	FOMC meeting	Feb	+25bp hike		
3/16/2017	Housing Starts	Feb	1260k	1246k	
3/17/2017	Industrial Production MoM	Feb	0.20%	-0.30%	
3/17/2017	Univ. of Mich. Sentiment	Mar P	97	96.3	

Japan

	Indicator	Period	Expected	Prior	Comments
3/13/2017	Machine Orders YoY	Jan	-3.70%	6.70%	Focus will be on the BoJ Meeting
3/13/2017	Tertiary Industry Index MoM	Jan	0.10%	-0.40%	
3/15/2017	Industrial Production YoY	Jan F	-	3.20%	
3/15/2017	Capacity Utilization MoM	Jan	-	0.60%	
3/16/2017	BoJ Meeting	Mar 16	No change		

Eurozone

	Indicator	Period	Expected	Prior	Comments
3/14/2017	Industrial Production MoM	Jan	1.40%	-1.60%	CPI print release will be important this week
3/16/2017	CPI YoY	Feb F	2.00%	2.00%	

United Kingdom

	Indicator	Period	Expected	Prior	Comments
3/16/2017	BoE Meeting	Mar 16	No change		Focus will be on the BoE meeting

China and India

	Indicator	Period	Expected	Prior	Comments
03/14/2017	Retail Sales YTD YoY (CH)	Feb	10.6%	10.4%	China industrial production and retail sales print along with India inflation numbers will be closely tracked by the market
03/14/2017	Fixed Assets Ex Rural YTD YoY (CH)	Feb	8.20%	8.10%	
03/14/2017	Industrial Production YTD YoY (CH)	Feb	6.20%	6.00%	
03/14/2017	WPI YoY (IN)	Feb	6.10%	5.25%	
03/14/2017	CPI YoY (IN)	Feb	3.60%	3.17%	
03/15/2017	Exports YoY (IN)	Feb	-	4.30%	

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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