US earnings and fading Europe risk compensate for reflation doubts

Equity markets got what they expected with the first round of the French elections producing for the run-off the establishment candidate Macron and the anti-establishment candidate Le Pen. Then on Friday, again as expected, US GDP growth slowed down considerably for the first three months of the year but markets kept up the gains that had materialized in the aftermath of the first round of the French elections. The Trump administration finally produced a draft tax reform proposal. It was much more a draft than a detailed proposal and leaves open many questions. The key issues are related to the financing of the proposed massive reduction of the corporate tax rate, as well as the implications that a massive deficit spending boost would have for monetary policy at a time when the economy is running at almost full employment. It is therefore legitimate to increasingly question the continuation of the Trump reflation trade. The narrowing of the US equity market, with tech stocks such as Google and Amazon again taking the lead, tells us that it is earnings that are again leading the market combined with an expectation that rates and yields will remain subdued. The fading of political risk in Europe is of course also helping.

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US data and Federal Reserve to take the front stage again

US equities' capacity to remain at record highs will this week be tested by a significant amount of data on the US economy and by what Mrs. Yellen will say on Wednesday after the FOMC meeting. Even if there have been signs of inflation picking up, we don't expect the Federal Reserve to aggressively change its tone as growth seems to be stabilizing again and – in spite of some upward indications last week – it is not yet clear how threatening inflation is. If the inflation data at the beginning of the week, and the labour data on Friday, will remain subdued, such wait-and-see attitude would be warranted. Also, there is still no clarity as to how inflationary the Trump tax plans will effectively be. Such plans might remain vague over the coming weeks as Congress needs to approve the temporary funding first to prevent a government shutdown. We expect markets to continue to move side wards as earnings and economic data confirm expectations and the Federal Reserve does not dramatically alter its rate outlook. Critically, it will be important to monitor how well Europe keeps up its current growth pace, and how soon and how fast China will tighten stimulus.

Past week global markets' performance

Index Snapshot (World Indices)

Index	Latest	Weekly Chg %	YTD %
S&P 500	2,384.2	1.5	6.5
Dow Jones	20,940.5	1.9	6.0
Nasdaq	6,047.6	2.3	12.3
DAX	12,438.0	3.2	8.3
Nikkei 225	19,196.7	3.1	0.4
FTSE 100	7,203.9	1.3	0.9
Sensex	29,918.4	1.9	12.4
Hang Seng	24615.1	2.4	11.9
Regional Markets (Sunday to Thursday)			
ADX	4512.9	-0.2	-0.7
DFM	3416.7	-1.5	-3.2
Tadawul	6945.7	0.7	-3.7
DSM	10089.9	-1.5	-3.3
MSM30	5525.43	0.9	-4.4
BHSE	1332.2	-0.2	9.2
KWSE	6854.3	0.6	19.2
MSCI			
MSCI World	1,878.3	2.0	7.3
MSCI EM	978.0	1.7	13.4

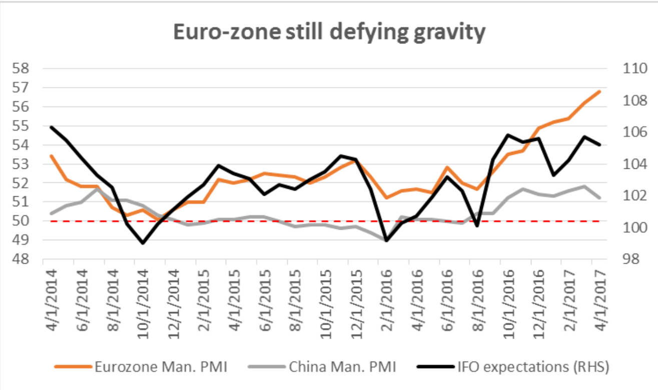
Global Commodities, Currencies and Rates

Commodity	Latest	Weekly Chg %	YTD %
ICE Brent USD/bbl	52.1	-0.4	-8.4
Nymex WTI USD/bbl	49.3	-0.6	-8.2
Gold USD/t oz	1268.3	-1.3	10.5
Silver USD/t oz	17.2	-4.0	8.1
Platinum USD/t oz	946.2	-2.7	4.8
Copper USD/MT	5688.5	1.6	3.4
Alluminium	1904	-1.1	12.4
Currencies			
EUR USD	1.0895	1.6	3.6
GBP USD	1.2951	1.0	5.0
USD JPY	111.49	2.2	4.9
CHF USD	0.9946	-0.2	2.5
Rates			
USD Libor 3m	1.1723	1.4	17.5
USD Libor 12m	1.7740	1.7	5.2
UAE Eibor 3m	1.4487	-0.6	-1.8
UAE Eibor 12m	2.2148	0.2	5.7
US 3m Bills	0.7923	2.6	59.3
US 10yr Treasury	2.2802	1.4	-6.7

Reflation trade in doubt but fading Europe risk and reasonable earnings sustain markets

Growth stabilizing, no escape velocity

Many times following the 2008 Global Financial Crisis (GFC) people have wondered whether the global economy might reach escape velocity. What was meant by that was a real growth rate sustainably above 3% in the United States and above 2% in Europe. Once more it is not happening. Once more, however, growth is not imploding either. The last leg of the 2016-17 reflation trade is now in full speed in Europe where confidence indicators are very strong. We sense that this is not sustainable. The Euro-zone in particular is a net savings' economic area, in fact it has the largest trade surplus in the world. With the euro now strengthening and growth slowing down in the two more dynamic large economies of the world – the United States and China – it is hard to see how Europe can maintain the current pace of growth.



Source: Bloomberg

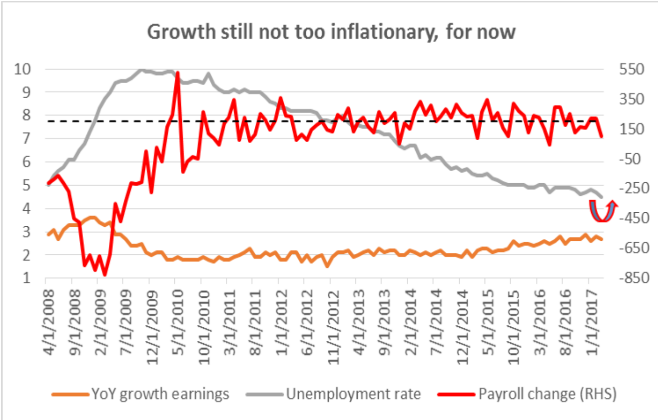
The above chart neatly illustrates our doubts. With stimulus in China (the grey line) already rolling over, German business expectations (the black line) are taking note. As such, Europe's business expectations are likely to roll over too, in line with expectations not only in China but also in the United States, as growth remains sustained but at subdued levels.

In these circumstances, we are unlikely to see a massive further jump in Europe's equities. Deregulation and better earnings are more likely to provide continuing upside to US equities, even if some further stalling of the rally would make sense. We are thus squarely assuming that markets will for now interpret the increase in geopolitical tensions – in particular the Far East – as mere noise. At the same time, and as we have been stressing for quite some time now, political risk in Europe is likely to remain low through 2017.

Focus back from politics to central banks?

At least this week we might well see a temporary shift back of the focus from politics to central banks, as significant US data is going to hit the markets and Mrs. Yellen will address the rate outlook following the FOMC meeting on Wednesday.

Whilst there are some signs that inflation has been creeping up again last week – in particular a significant jump in the Employment Cost Index and a rise in the breakeven inflation rate – the consolidation of the growth path, combined with some likely moderation in the tightening of the labour market are likely to allow the Federal Reserve to not, for now, dramatically change its rate outlook. If, as expected (and illustrated in below chart), job creation for April will have stalled below 200k, average earnings growth will remain stationary at 2.7% and, critically, the unemployment rate marginally edges up, then such prudent stance would make imminently stance.



Source: Bloomberg

Referendum rally in Turkish bonds

Turkish assets have welcomed the referendum result. The dollar bond yields have dropped lower while the Turkish lira has erased most of its previous losses this year. This recent rally clearly indicates that market participants which were underweight before the referendum have now turned overweight as the prospects of political stability have improved. The domestic situation is likely to remain stable with the next presidential elections unlikely to take place before 2019. This should allow President Erdogan to introduce more prudent fiscal policies that put the rising inflationary pressures in check. Separately, rising growth prospects in Europe are also likely to prove positive for the Turkish economy which heavily exports to the European Union. At the same time, similar to most of the emerging markets, Turkey should benefit from the recent consolidation in US Treasury rates.

In terms of valuations, Turkish bonds appear attractive in spite of the recent rally. The dollar bonds continue to trade cheap to the emerging market bonds where historically they have traded at a premium versus the emerging bond benchmarks. As such, we stick to our tactical overweight stance on Turkey fixed income for now and are comfortable exiting only when yields go lower than the levels seen before the failed July coup in 2016.

Summary market outlook

Bonds	
Global Yield	Positive French election results boosted risk appetite and reduced demand for safe haven assets. However, weak US GDP and ongoing US-North Korea tensions kept the yields consolidated at lower levels. Treasury market is likely to remain supported, particularly if the Fed proves dovish at the upcoming meeting. In Europe, bond yields came under pressure after the positive French elections outcome and higher than expected inflation (particularly core) print. With signs of political risk receding in Europe, we expect German Bund spread to widen versus US Treasuries.
Stress and Risk Indicators	The VIX stooped to its lowest level in three years, driven by the positive French election outcome. However, the current levels are too low given the ongoing global political uncertainty and we expect volatility to rise. .
Equity Markets	
Local Equity Markets	GCC equity markets were mixed as oil prices continued to remain under pressure. We remain neutral on GCC equities given the potential for further dollar strength and limited upside in oil prices.
Global Equity Markets	Global stock markets ended the week higher as risk appetite jumped post the French election. European markets were the best performer, boosted by the positive sentiment and string of robust earnings results. Japanese markets also performed well as the yen weakened after the BoJ confirmed that monetary stimulus will continue. US equities were in green mainly on account of positive earnings results and less so due to the Trump tax plan. We expect the equity markets to remain side-lined ahead of the FOMC meeting this week.
Commodities	
Precious Metals	Gold prices declined as markets moved to a “risk-on” mode post the French election results. Nevertheless, we stick to gold as a risk hedge against ongoing political and inflationary risks.
Energy	Energy prices continued to decline on uncertainty over the extension of OPEC cuts and expanding US crude inventories. While we expect some upward normalisation to take place, we argue against any significant jump as the rising US rig count and downbeat China demand should weigh on energy prices.
Industrial Metals	Industrial metals were mixed in spite of weaker dollar. We expect industrial metals to remain under pressure given ongoing concerns around Chinese demand.
Currencies	
EURUSD	The euro appreciated versus the greenback, boosted by the French election results and strong inflation print. This trend is not sustainable given the diverging central bank policy in Europe versus US.
Critical levels	R2 1.0990 · R1 1.0942 · S1 1.0852 · S2 1.0810
GBPUSD	The pound strengthened versus the dollar in spite of a weaker than expected 1Q GDP release. Recent pound strength looks overdone as risks of “hard Brexit” are to remain.
Critical levels	R2 1.3012 · R1 1.2981 · S1 1.2905 · S2 1.2859
USDJPY	The yen fell against the dollar mainly on the back of the dovish BoJ stance. We expect the yen to weaken further given the potential for dollar strength.
Critical levels	R2 112.07 · R1 111.78 · S1 111.13 · S2 110.78

Forthcoming important economic data

United States

	Indicator	Period	Expected	Prior	Comments
05/01/2017	PCE Deflator YoY	Mar	1.90%	2.10%	All eyes will be on the FOMC meeting. PCE core and wages data will also be important.
05/01/2017	PCE Core MoM	Mar	-0.10%	0.20%	
05/01/2017	Markit US Manufacturing PMI	Apr F	52.8	52.8	
05/01/2017	ISM Manufacturing	Apr	56.5	57.2	
05/03/2017	FOMC meeting	Mar	No change		
05/04/2017	Durable Goods Orders	Mar F	0.70%	0.70%	
05/05/2017	Change in Nonfarm Payrolls	Apr	190k	98k	
05/05/2017	Unemployment Rate	Apr	4.60%	4.50%	
05/05/2017	Average Hourly Earnings MoM	Apr	0.30%	0.20%	

Japan

	Indicator	Period	Expected	Prior	Comments
05/01/2017	Nikkei Japan PMI Mfg	Apr F	-	52.8	Light week in terms of data.

Eurozone

	Indicator	Period	Expected	Prior	Comments
05/02/2017	Markit Manufacturing PMI	Apr F	56.8	56.8	GDP and PMI will be the main focus this week.
05/03/2017	PPI YoY	Mar	4.20%	4.50%	
05/03/2017	GDP SA QoQ	1Q A	0.50%	0.40%	

United Kingdom

	Indicator	Period	Expected	Prior	Comments
05/02/2017	Markit PMI Manufacturing SA	Apr	54	54.2	PMI will be important.

China and India

	Indicator	Period	Expected	Prior	Comments
05/02/2017	Caixin China PMI Mfg (CH)	Apr	51.3	51.2	Not many data releases scheduled except for PMI.
05/02/2017	Nikkei India PMI Mfg (IN)	Apr	-	52.5	

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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