WEEKLY MARKET OUTLOOK

10 - 16 December 2018

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WEEKLY MARKET OUTLOOK - An Overview

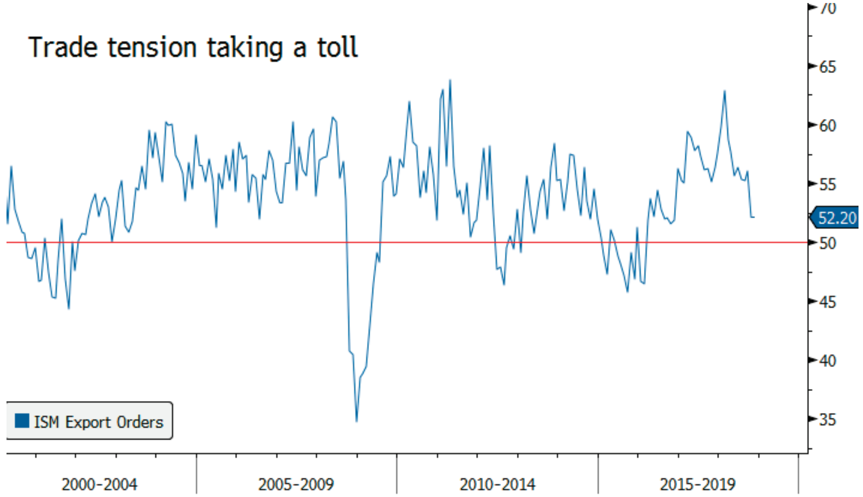
Economics

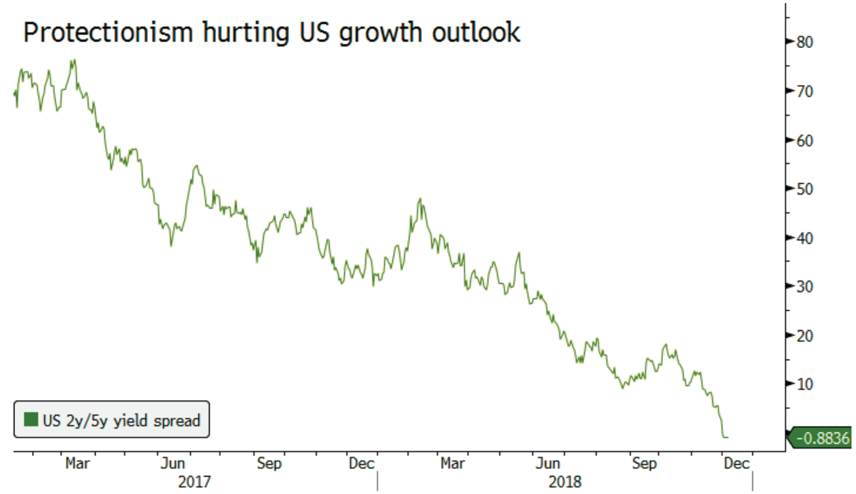
Trump trade policy debacle

Just when you thought that US President Donald Trump could not mismanage trade policy or his administration any further, we get Huawei's chief financial officer being detained at a Canadian airport on a US extradition request. This come on the heels of sensitive US-China relations and a temporary truce in the so-called trade war in the wake of the G20 dinner discussions in Argentina.

As expected, Beijing is furious, demanding Meng Wanzhou's release and declaring the arrest a human right violation. While Trump claims that he had no knowledge of the impending arrest when he met with China's President Xi Jinping, news has broken that John Bolton, his National Security Advisor, was aware of it. Reuters has indicated that the arrest was connected to an alleged scheme to evade US sanctions again Iran using the global banking system, which some claim is controlled by the US.

Inevitably, market reaction was extremely negative (S&P 500 suffering one of the largest single-day drops of the year) and it was saved only by rumors that the Fed might consider slowing the pace of rate hikes. Hopes that a full deal could be reached in 90 days seem like a pipe dream now. It is unlikely that the public disrespect shown by the US will be forgotten quickly. In addition, mixing business with politics is a dangerous business but one that China is well versed in. With the global growth outlook already weak, expectations for a full-blown US-China trade war will only hurt further. The US yield curve is moving from flat to negative on the short end but the trend is towards a full inverted curve indicating a US recession.





Economics

The Fed To Take One Foot Off

There are increasing evidence that the Federal Reserve is moving towards a data dependent strategy amid tumultuous financial market conditions and concerns over slowing global growth. Indeed, sticking to the usual quarterly hike pattern has become dangerous for the Federal Reserve as, according to Jerome Powell, interest rate are "just below" broad estimates of a level considered neutral, i.e. a level considered to neither accelerate of slowdown economic growth. However, at the long-end of the curve, it is a completely different story, as the Fed has not stopped unwinding its massive balance sheet, which means that on the long-end of the curve rates would most likely continue to grind higher. In addition, since October 2018, the Fed has increased the pace of unwinding to $50bn per month ($20bn for agency debt and agency MBS and $30bn for Treasury securities). For now, the consensus is that the Federal Reserve is aiming at reducing its balance down to $2.5-3 trillion; currently, it stands slightly above $4 trillion. However, it appears more and more likely that Jerome Powell would have to slowdown or even interrupting that process before reaching those levels.

Indeed, as of October 2018, the US Public debt was at $21.8 trillion, while the US total debt - which includes household, business, state and local governments, financial institutions and the federal government - passed the $70 trillion mark as private debt soared consistently over the last decade. Between 2010 and 2018, non-financial corporation added more than $3.5 trillion in debt, which brought it to a total of $9.5tn. Over the same period, consumer credit debt by increased by $1.4tn to $3.9tn. Student loan debt stands at $1.5tn and credit card debt just passed the $1tn mark.

The point here is that the debt servicing cost is going to increase gradually as the Fed moved forward with its balance sheet normalization process. In 2017, the US Treasury paid $458 billion in interest expense, while estimates for 2018 stand around $500bn. Therefore, one could reasonably expect that this figure will rise significantly in the coming years as interest rates go up. Indeed, today the average interest rate over the government's interest-bearing asset stands around 2.5%, compared to 4.9% in October 2007 (pre-crisis benchmark). Assuming that the average interest rate return around that level, it means that the government would have to pay more than $1,000 billion in interest per year. That would be unsustainable.

The main takeaway from this observation is that the Fed would have no choice but to slow down significantly its normalization process, which would affect both the hiking cycle and balance sheet unwinding. Ultimately, it should translate into a weaker USD as investors start to integrate those developments into asset prices.

Economics

UK Parliament Withdrawal Vote Is Not A Dead End

Parliamentary debates have intensified since last Tuesday and are coming to an end. Since the decision of the British Cabinet to validate the Withdrawal Agreement, it is becoming less and less obvious that UK MPs will be following the same move. The recent amendment passed by the UK parliament to take the hand over PM May in the event of a no-go is an evidence of it. In any case, Theresa May's government will be facing a difficult challenge, since it requires the approval of 320 MPs out of 650 in total in order to pass the bill.

Indeed, criticism is mounting among both Brexiteers and pro EU backers due to dissatisfaction concerning current arrangement that requires the UK to maintain close ties with the EU without having the right to speak out while accepting enforcement of EU rules and commit to contribution of EU budget (est. along GBP 39 million) for 2019 and 2020. Although the agreement is allowing the UK to gain some time until end-November 2020 to draft a complete, widely accepted divorce, the negative side of the agreement relating to the two-tier backstop that includes the UK and Northern Ireland while maintaining current terms unchanged, could be a fatal defeat for UK PM May. Losing the face in front of the assembly, PM May would be losing support within the Conservative party and would either way be forced to execute what the UK Parliament orders, or resign (voluntarily or forced).

Accordingly, as the option of a hard Brexit would be the least desired outcome for both the UK and EU (e.g. trade and free movement issues, economic losses caused by backlogs of customs controls, supply chain adjustment costs, etc.), it appears clear that the most realistic step to be implemented by the UK government, aside from asking further concessions from the European Commission to close a deal before 29. March 2019, is to extend the transition period specified in Article 50 of the treaty, allowing the UK to buy a few months time to finally close a deal. Although this resolution would still not resolve sticking problems, it remains the most realistic short-term solution. The perspectives of a new trade agreement ("Norway Plus"), new general elections, a second referendum or a unilateral withdrawal from Article 50 will be the options undertaken looking forward.

For now, it seems apparent that the British pound should move based upon headlines. 3-months at-the-money implied volatility on the cable, given at June 2016 high, suggests that investors are pricing in a hard Brexit scenario, although other alternatives remain. Under the circumstance of a rejection of the deal on Tuesday, we expect the GBP to face difficult times during the week.

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