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Global Markets

Global Macro Thoughts

Setting Out Our Stall

Global financial markets are facing a potentially more challenging environment in 2018/2019 as central banks begin to pare back monetary and fiscal stimulus and embark on the (hopefully gradual) process of balance sheet normalization

The global economic recovery post the financial crisis, fueled and emboldened by quantitative easing, will now be put to the real test. Economic growth must prove itself sustainable as the central bank life-support system is turned down

- The **v**elocity of this normalization process will be key to how global markets react; to avoid adverse reaction across the risk asset space, central banks need to convey 'dovish tightening strategies'
- We believe that Central Banks will maintain a very gradual approach to policy normalization, cognizant of the potential market shock that any overly hawkish rhetoric could create

Longer dated core global yields are edging higher as the Bank of Japan becomes the latest central bank to announce a reduction in bond purchases

- 10y UST yields have broken through the 2.50% mark for the first time since mid-March, with the 2.60% 10 month high now on the horizon
- The European Central Bank may have begun scaling back asset purchases, but it is still the marginal buyer of risk in that region, helping to keep yields anchored
  - ECB held >EU130bn of corporate bonds (EU2.29tn total asset purchase program holdings) as of January 5.
  - German government bond yields still negative out to 5Y
  - The 10Y bund may be off its 2016 -0.189% low, but at only +0.466% still reflects financial repression and a degree of overarching investor caution

The prospect of a higher yield structure over the coming months could be catalyst for risk asset price weakness and spread widening as investors adjust their asset allocation strategies, able to achieve a given yield bogey in more defensive assets

- The hunt for yield has driven investors further down the quality curve over the past several years in search for incremental portfolio returns, resulting in spread compression and flatter risk curves

With inflationary pressures now expected to grow as the full effect of quantitative easing and persistently low interest rates is felt around the globe – with the result of pushing underlying yields higher – one clear implication for investors will be the need to hedge the interest rate risk in their portfolios.

- This could be done with either specific hedging strategies or simply through the process of scaling back risk exposure
- Expectations of a higher interest rate structure over the coming quarters may also spur borrowers to lock in funding at the earliest opportunity

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- As such, the confluence of a more defensive bias among investors as they are able to shift into (then higher yielding) more defensive assets for the same yield target, and borrowers attempting to front-load funding, could trigger a renewed bout of market volatility.

But there is no imminent need for investors to be overly concerned. The withdrawal of central bank stimulus and balance sheet normalization seems to be gradual at best for the time being; the more bearish macro forecasts would paint a sustainable return to higher interest rates as aspirational.

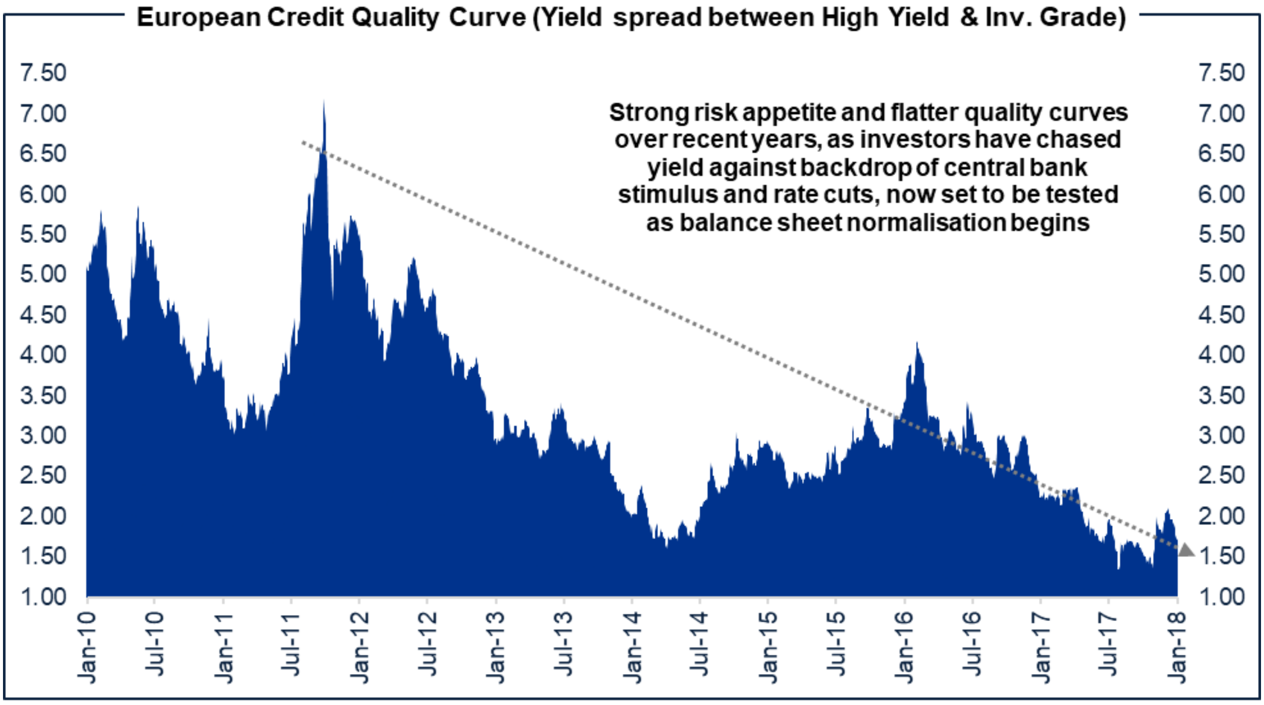
- Indeed, the global macro-economic outlook remains fragile, suggesting that while central banks may have begun the process of tapering stimulus, there seems little risk at this stage that they will seek to liquidate asset holdings
    - We expect QE/asset purchase portfolios to be left to run off at worst, while the ECB has stated that it remains ready to expand asset purchases again should the macroeconomic evolution disappoint; this supports the near-term outlook for risk assets

Post-GFC economic growth has been fueled by central bank CB stimulus, which has seen most advanced and developing economies close the output gap between actual and potential economic growth; as such it may now be difficult to extend gains, even if stimulus remains constant, in the absence of structural reforms and new capital investment drives.

Moreover, the economic growth outlook will be constrained by approaching full employment (especially in the U.S.) and the implied rise in inflationary pressures; this will add weight to the case for monetary tightening (further stimulus withdrawal), which in turn will dampen the growth outlook

- Global economic growth has peaked, says World Bank; expects (G10) growth to slow from 2.3% last year to 2.2% this year and 1.7% by 2020
- I see the MENA economic outlook as remaining optimistic though; the recent uptick in oil prices and accommodative financial conditions should help to cushion against broader global growth uncertainties
- Furthermore, the UAE economy is expected to register +3.9% growth this year, underpinned in part by positive FDI (+2/+3% growth) as well as growth in tourism and travel, as per the UAE Central Bank.

Bottom line: Macro uncertainties continue to support the case for the aforementioned 'dovish tightening strategies', although the path of least resistance for global yields through 2018 seems to remain higher.



Source: Bloomberg; FAB

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