

Weekly Market Summary

10th of June 2016

A Clueless Federal Reserve Record Low Yields And Undecided UK Voters !!

Fadi Nasser (SVP – Head of Treasury Sales)

Two weeks ago, I wrote about bond traders getting it wrong all over again and suggested that investors' reach for yields - by extending maturities, moving down on the credit curve or some combination of the two - would soon backfire given renewed easing in global financial conditions, a stabilizing China, an improving US economy and recent hawkish Fed speak. I also sincerely believed it would be wise to warn our valuable clients that sooner or later economists and the Fed will be right again, the case for more aggressive interest rate hikes would become clearer to all, and when that happens the resulting abrupt sentiment turn in the market will surely translate into a violent bond reversal and much higher yields! Needless to point out how premature or "possibly" inaccurate such assessment would turn out to be!!

The real turnaround in markets – though towards lower yields - began some 10 days back, when various UK polls on EU started showing a lead for the Leave Camp (rising uncertainties, in turn translating into risk-off sentiment). That was followed by a disastrous US Non-farm payroll report on June 3rd, a benign 38,000 increase in jobs for May versus market expectation for a 160,000 increase! (Funny that we are always reminded that one month data doesn't make a trend when payroll or inflation data print on the strong side!). As a result, US rate hike expectations suffered a considerable blow, with markets now fully discounting a Fed on hold at the upcoming June 15th FOMC meeting, and a small 16% probability for a July 27th rate hike (surely my view on that outcome does not matter any longer! L).

Federal Reserve Chairman Janet Yellen - speaking at the World Affairs Council of Philadelphia on June 6th - called the weak jobs data "*concerning*", but was quick to stress her optimism in the path of the US recovery, citing previous large employment gains, wage growth and the relatively low number of Americans filing new claims for unemployment insurance. Yellen added that the current level of short term interest rates - just above zero - is "*generally appropriate*," but that she expects the Fed to raise rates in the future "*provided that labor market conditions strengthen further and inflation continues to make progress toward our 2 percent objective.*" This dousing of an imminent shift higher in US borrowing costs (effectively that is how markets interpreted Yellen's remarks) prompted investors to buy equities, corporate debts and commodities. As Wall Street took a shot at setting a new record high for the S&P 500 and oil's momentum sought traction beyond \$50 a barrel, 10-year US Treasury yields also slipped and closed below 1.70%, a floor that prevailed in the wake of market stress peaking back in February (back then though, stocks were down in excess of 10% from current levels, China was in turmoil and oil had just hit a fresh low!).

How much longer can the Fed tolerate that the market completely ignores its signals is the question that should be on everyone's mind? Admittedly, the Fed's - as well as other central banks' - behavior and about-face guidance over the past few years is a major cause for this credibility crisis. Nonetheless, that surely does not mean that it now has to accept the current situation. Whereas over the past years Chair Yellen used every totally irrelevant data

publication as an argument against rate hikes, she - and her colleagues - are now very open on improving US economic trends and the need for gradual rate hikes going forward! Only this time around, the market does not want to believe it (that possibly explains why Guru Bill Gross warned yesterday that the current \$10 trillion of negative yielding bonds is a '*supernova that will explode one day!*').

Moving to the UK, and with less than two weeks to go until the EU Referendum, the polls have narrowed from last month with 'Remain' and 'Leave' camps both neck and neck (in fact the "Leave" camp has the lead now in the latest polls). Economists and strategists agree that a 'Leave' vote would trigger a major risk off event, possibly including a UK recession, a 10-15% drop in the value of the British Pound, a 5-10% drop in global equity markets and Bank Of England (BOE) rate cuts (whilst a major risk-on rally would set in place should the "Remain" vote prevail).

With that message well-advertised, one remains puzzled that just a quarter of voters believe that Britain leaving the European Union would make them poorer, according to new polling that suggests the remain campaign's central message is failing to hit home. Britain Stronger in Europe has poured resources into convincing the public that a vote to leave on June 23rd would jeopardize economic growth and hit jobs, and the UK Treasury published research suggesting it would cost the average household £4,300. And while 63% of those polled by Ipsos Mori thought leaving the EU would reduce immigration – the central thrust of the leave campaign – just 25% think it would reduce their own living standards! The poll also suggests that with a fortnight to go before the vote, the remain camp's key proposition – that leaving the EU would "*put a bomb under the economy*", as David Cameron called it – has either not reached the public, or is not believed. More than a tenth of voters – 13% – said they believed they would be better off after a Brexit; the remainder said it would make no difference, or they didn't know. The same survey also revealed a series of public misperceptions about the EU and what it means for daily life: Those surveyed believe 15% of the population (10.5 million people) is made up of EU migrants, compared to 5% (3.5 million people) in reality. Voters also tended to overestimate the UK's financial contribution to the EU, the research found, with nearly a quarter (23%) saying the UK is the single top contributor, while in reality, it is fourth, behind Germany, France and Italy. Clearly, now is the time the UK public gets provided with as much factual information about the EU as possible before they cast their final vote!

Disclaimer

It is important that you only use this report if you are the intended recipient of this report and you have satisfied yourself that you are eligible to receive such information. This report is provided to you because you are one of our esteemed customers and have previously shown interest in receiving the type of information contained in this report.

The Treasury and Investment Management department of Gulf International Bank B.S.C. ("GIB") have compiled the information in this report. GIB is incorporated in the Kingdom of Bahrain and is licensed by the Central Bank of Bahrain (the "CBB") as a conventional wholesale bank. GIB's head office is located at Al-Dowali Building, P.O. Box 1017, 3 Palace Avenue, Manama, Kingdom of Bahrain.

This report is intended for the accredited investors, as defined in the Investment Business Code of Conduct published by the CBB. This information has not been reviewed by the CBB or any other regulatory authority in any jurisdiction and neither CBB nor any other regulatory takes any responsibility for the correctness or accuracy for the information contained in this report.

The information contained herein is not directed at or intended for use by any person resident or located in any jurisdiction where (1) the distribution of such information is contrary to the laws of such jurisdiction or (2) such distribution is prohibited without obtaining the necessary licenses or authorizations by the relevant branch, subsidiary or affiliate office of GIB and such licenses or authorizations have not been obtained. The recipient of such information is responsible for ensuring that this information has not been received by it in breach of laws and regulations of any jurisdiction.

This report contains publicly available information only, which has only been compiled by GIB. The information provided herein is on "as is" and "as available" basis and without representation or warranty of any kind. GIB hereby disclaims any representation or warranty, express or implied, as to the accuracy, timeliness, completeness, merchantability, fitness for any particular purpose or non-infringement of any of such information. In no event shall GIB or its subsidiaries, affiliates, shareholders or their directors, officers, employees, independent contractors, agents and representatives (collectively, "GIB Representatives") be liable (1) for any inaccuracy, delay, loss of data, interruption in service, error or omission or for any damages resulting there from, or (2) for any direct, indirect, incidental, special, compensatory or consequential damages arising from any use of information or arising from any error (negligent or otherwise) or other circumstance or contingency within or outside the control of GIB or any GIB Representative, in connection with or related to obtaining, collecting, compiling, analyzing, interpreting, communicating, publishing or delivering any such information. The information here is, and must be construed solely as, compilation of information (unless expressly stated otherwise) and not statements of fact as to credit worthiness or recommendations or opinions of GIB.

This report does not provide individually tailored investment advice. Any materials contained herein have no regard to the specific investment objectives, financial situation or particular needs of any specific recipient. The document is provided for information purposes and is not to be construed as a solicitation or an offer to buy or sell any securities or related financial instruments. GIB makes every effort to use reliable, comprehensive information, but we do not represent that it is accurate or complete. No representation or warranty, either express or implied, is provided in relation to the accuracy, completeness or reliability of the materials, nor are they a complete statement of the securities, markets or developments referred to herein. Recipients should not regard the materials as a substitute for the exercise of their own judgement. Any opinions are subject to change without notice and may differ or be contrary to opinions expressed by other business areas or groups of GIB as a result of using different assumptions and criteria. GIB is not under any obligation to update or keep current the information contained herein.

The value of, and income from, your investments may vary because of changes in interest rates or foreign exchange rates, securities prices or market indexes, operational or financial conditions of companies or other factors. Past performance is not necessarily a guide to future performance. Estimates of future performance are based on assumptions that may not be realised.

The information contained in this report is just for informational purposes. Information does not constitute a solicitation, an offer, or a recommendation to buy or sell any investment instruments, to effect any transactions, or to conclude any legal act of any kind whatsoever. GIB does not intend to provide investment, legal or tax advice through this report and does not represent that any securities or services discussed are suitable for any investor. When making a decision about your investments and business, you should seek the advice of professional advisors.

The report may contain statements that constitute "forward looking statements". While these forward looking statements may represent GIB's judgment and future expectations, a number of risks, uncertainties and other important factors could cause actual developments and results to differ materially from GIB's expectations. GIB is under no obligation to (and expressly disclaims any such obligation to) update or alter its forward-looking statements whether as a result of new information, future events, or otherwise. The historical information is provided for information purposes only. Performance figures are calculated before tax (if any) and after deducting ongoing fees and expenses. The performance figures are historical and past performance is not necessarily an indication of future results. Certain amounts (including %ages) included in this document may have been subject to rounding adjustments. Accordingly, figures may not be an exact arithmetic aggregation of the figures to which they relate. The values and forecasts shown represent our current indicative valuations and forecasts of the relevant transactions, currencies, interest rates, commodities or securities as at the date shown. Any value or forecast shown herein is not an indicative price quotation. We expressly disclaim any responsibility for the accuracy of the values or forecasts shown, any errors or omissions in the report.

With the exception of information regarding GIB and save as otherwise specifically indicated, the information set out in this report is based on public information. We have, where possible, indicated the primary source of information. We strongly recommend the recipients consult the primary source of information. Facts and views in this report have not been reviewed by, and may not reflect information known to, professionals in other GIB business areas.

This Report, and the information contained herein (save to the extent that such information is publicly available) is confidential and may not be disclosed by you to any other person outside of your organization without our consent.

GIB retains all right, title and interest (including copyrights, trademarks, patents, as well as any other intellectual property or other right) in all information and content (including all text, data, graphics and logos) in this document. All recipients must not, without limitation, modify, copy, transmit, distribute, display, perform, reproduce, publish, license, frame, create derivative works from, transfer or otherwise use in any other way for commercial or public purposes in whole or in part any information, text, graphics, images from this document (excluding publicly available information) without the prior written permission of GIB.