

# Weekly Market Summary

Nov 10th, 2017

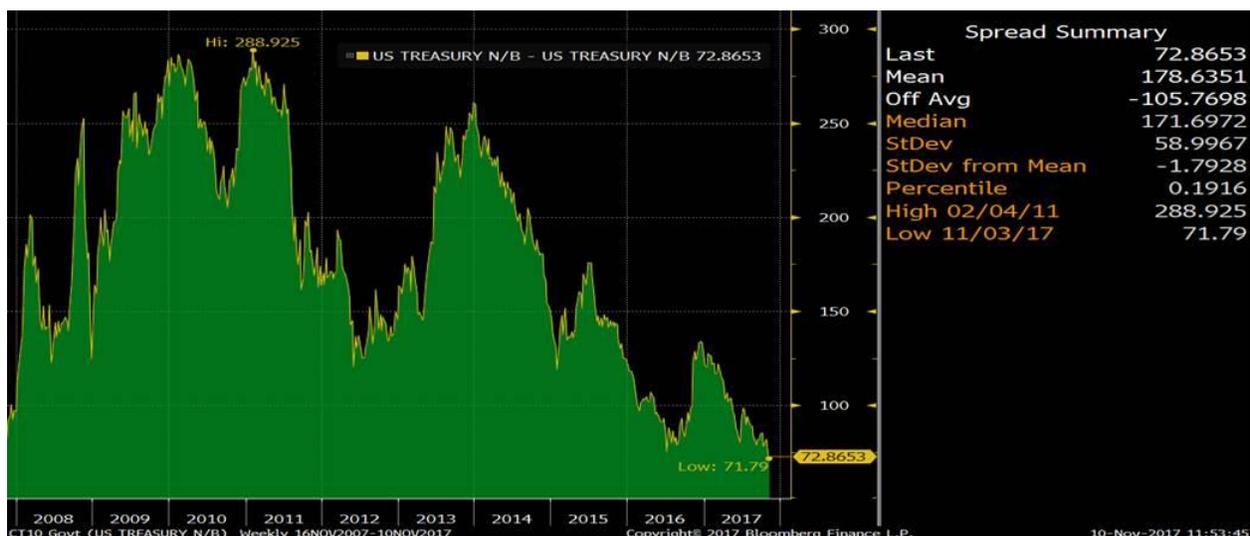
**Stubbornly Flat Yield Curves and a Worrying Escalation in Regional Tensions !!**  
**Fadi Nasser - Deputy Chief Investment & Treasury Officer**

In mid-August, I released a piece entitled “*Strong Economic Data on Both Sides - and I Mean Both Sides ... But Market Focus Is Elsewhere*”, where I noted strengthening economic data on both sides of the Atlantic and business resilience in the face of rising political/geopolitical pressures. Positive second-quarter growth readings had just shown global output rising at its most rapid pace in 2-1/2 years, and the world economy appeared well on its way to a year of faster and firmer growth. Even more encouraging this time around was the fact that the expansion was broad-based, as long-time laggards Japan and the Euro area had finally joined the party.

This positive economic assessment was followed in early October with a confirmation from the International Monetary Fund (“IMF”) that the world economy was enjoying its most widespread and fastest growth momentum since a temporary bounce back from the global recession in 2010. In a rare upbeat “*World Economic Outlook*”, published at the start of the annual meetings of the IMF and World Bank in Washington, the Fund added that the unexpectedly good news had further to run in 2018 and higher investment was also beginning to improve the longer-term economic prognosis. “*This is not bounce back from a sharp deceleration, this is an acceleration from the fairly tepid growth rates of recent years, so that is really good news.*” Maurice Obstfeld - chief economist of the IMF - told the FT in an interview ahead of the report’s publication (The IMF estimates that the world economy will expand 3.6% in 2017, up from 3.2% recorded last year, and it is likely to grow 3.7% in 2018).

And yet, the U.S. yield curve just keeps getting flatter, reaching levels not seen in a decade (last at 72.8 bps for the 2yr-10yr UST yield spread)!!

**2-year US Treasury / 10-year US Treasury Interest Rate Differential (2007 – 2017)**



What that says about investors' economic outlook depends on who you ask: To Rick Rieder at BlackRock Inc., long-term Treasuries are "*crazy priced wrong to the expensive side*," along with debt in Europe and Japan, in part because investors in those regions flock to the U.S. any time debt prices fall. That appetite keeps 10-year Treasury yields in a tight range even as the Federal Reserve sees economic growth warranting additional interest-rate hikes. Bill Gross at Janus Henderson Group has a gloomier view; For him, the central bank is nearly at its limit for raising rates, given how much debt is out there in the market place. The yield curve from two to 10 years, which dipped to a low 71 basis points last week, only needs to flatten 20 to 30 basis points more to signal an impending economic slowdown, Gross said, adding that it has been a reliable recession indicator in the past. These differing interpretations show how investors are struggling to balance the prospect of further Fed tightening against a backdrop of low inflation (at least for now), coupled with the lowest jobless rate since 2000 and potential for large US fiscal stimulus in coming months.

Previously, the slope of the yield curve was considered a leading indicator of growth (not anymore if you ask me, especially in the era of unrestricted printing of Fiat Currency by various central banks!). Regardless of the economic signals that one takes away from the shape of the yield curve, there is a consensus on Wall Street that the price zigzags bond traders have witnessed all year are likely to continue. With ECB Executive Board member Benoit Coeure confirming yesterday that the Euro-area recovery is the strongest and most balanced in "*almost 20 years*," as well as the latest US Fed's Senior Loan Officer Survey figures showing that the net percentage of banks tightening lending standards has fallen to the lowest since 2014 (easing lending conditions constitute a leading indicator for future growth), I remain firmly in the same camp as Rick Rieder, predicting long-term rates will soon explode to the upside - at a time "*herd mentality*" analysts/traders wants us to believe otherwise (Bloomberg's latest article "*Flat Yield Curve Could be Supercharged If Key Marks are Breached*" argues for a further move lower in long term rates).

Moving to the region, a sequence of escalatory moves in the Gulf in past week suggests the long-brewing cold war between Saudi Arabia and its regional arch-rival Iran could soon grow hotter. It all began with the surprise resignation of the Lebanese prime minister, Saad al-Hariri, announced on Saturday afternoon from Saudi Arabia. Hours later, in Yemen, a ballistic missile was fired by Iran-backed Houthi rebels towards Riyadh airport. Saudi Arabia later accused Iran of an act of war over the incident; That same evening, some of the most powerful figures in Saudi Arabia were arrested and detained following three years of active investigations (currently the number is slightly in excess of 200, according to the Kingdom's attorney-general – whilst seven have been released without being charged), as part of a new anti-corruption crackdown into at least US\$ 100 billion in systematic embezzlement cases going back decades (in past 2 days, the Saudi graft probe has extended beyond the Kingdom's banking system, specifically to the UAE – the region's financial hub – where many Saudis invest in equities/real estate projects and keep deposits).

Also earlier this week, King Salman of Saudi Arabia summoned Mahmoud Abbas, president of the Palestinian Territories, to a meeting, raising suspicions that Mr. Abbas too was coming under pressure from Riyadh after reaching a power-sharing deal with Hamas, the Iran-backed militant group. For the past years, Riyadh has watched closely Iran's influence grow stronger in the region. Tehran's allies in Iraq and Syria, including President Bashir al-Assad, have lately won a string of victories. Eager to regain influence in the region, Saudi Arabia has ratcheted up its diplomatic efforts this year, whilst also shifting towards a more forceful approach. "*All of the activity has to do with an effort at restructuring the geopolitics and geo-economics of the region*," says Theodore Karasik, senior adviser at Gulf State Analytics, a US-based consultancy. Regional diplomats – however – consider the moves as tough and sudden, increasing the chance of renewed regional flare-ups and proxy wars. That is surely in contrast to US president Donald Trump's view, who tweeted early Tuesday that King Salman and Crown Prince Mohammed Bin Salman "*know exactly what they are doing*." A second tweet late that day said "*some of those they are harshly treating have been 'milking' their country for years!*"

With tensions running high in the region, and arrests in the Kingdom seen as consolidating power for Crown Prince Mohammed bin Salman – who supports extending OPEC-led output cuts – oil prices have continued their march higher, heading for a fifth weekly advance. Whilst prices eased in the past 24 hours, following record weekly U.S. oil production and a surprise increase in crude stockpiles, they remain largely up on the week. Brent crude is last seen at \$ 64 a barrel, having traded as low as \$ 45 in last June of this year!

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