
Weekly Market Summary

Feb 16th, 2018

Exploding US Budget Deficits, a Quivering Bibi and Persisting Geopolitical Uncertainties

Fadi Nasser - Deputy Chief Investment & Treasury Officer

Last Monday, the White House proposed taking an additional decade to balance the US budget – effectively abandoning a pledge from last year to close the deficit within the coming 8-10 years, and instead saying its new plan would now see the budget in deficit until fiscal 2039 - as it delivered a spending plan that relies on aggressive growth predictions to close a ballooning budget gap, drawing increased scrutiny from financial markets. The \$ 4.4 trillion proposal for fiscal 2019 calls for \$ 200 billion in infrastructure spending over the next decade. Such announcement comes on the heels of Donald Trump's approval for a two-year spending bill that includes big increases in defence and domestic programmes. Mick Mulvaney, head of the budget office, said the plan is not "*dead on arrival*", as he urged Congress to take a more aggressive stance in tackling spending. "*Is this dead on arrival?.. Absolutely not. It simply highlights the fact that this is a messaging document,*" said Mr Mulvaney. "*The other message is that we do not have to have trillion dollar deficits for ever.*"

The release of the budget comes amid growing anxiety in financial markets over the prospect of rising interest rates and the wisdom of injecting fiscal stimulus into an economy at or near full employment. The benchmark 10-year Treasury bond on Monday traded near a four-year high of 2.86%, and rallied further during the week to a high of 2.92%, reflecting investor nervousness that the Federal Reserve may need to put a brake on an over-heating economy. Although the GOP (i.e. the Republican Party, commonly referred to as the Grand Old Party) controls Congress, the White House has blamed Democrats for the \$1.2 trillion budget deficit that will emerge next year due to last week's two-year deal. House Minority Leader Nancy Pelosi of California says the president's play would raise tolls on commuters, increase the burden on cities and states, and sell essential infrastructure to the whims of Wall Street. Senate Minority Leader Chuck Schumer of New York says Trump's plan would put unsustainable burdens on local government and called it a "*plan to appease his political allies, not to rebuild the country.*" Additionally, prominent economists and Wall Street bankers have questioned the wisdom of running deficits at a time when the economy is recovering well. "*It's obvious that it's the wrong timing for a deficit,*" said Olivier Blanchard, a former chief economist for the IMF. But the latest plan has also drawn some applause from asset managers who have been calling for measures to unlock spending on infrastructure in the world's largest economy. The centrepiece of the budget is the \$ 200 billion infrastructure plan that Mr. Trump wants to use to spur \$1.5 trillion in spending on roads, bridges and energy infrastructure. It calls for cuts for civilian agencies such as the State Department and the Environmental Protection Agency, which have proven unpopular with lawmakers in the past. Under the White House plan, EPA spending would be cut by 34% compared with its 2017 levels, while State spending would be cut by 26%. Pentagon spending would rise by 13% compared with 2017, while homeland security spending would rise 8%, as Mr. Trump presses his plan for a wall on the US-Mexico border.

Another serious issue at play is the fact that Donald Trump had previously suggested - when running for office - that he would pay off America's national debt in just eight years (*or is that FAKE news too Mr. President?!),* but he instead appears set to preside over a period of extraordinary fiscal indiscipline! Rand Paul has already accused his fellow Republican colleagues of hypocrisy over the deficit. Running up a \$ 1+ trillion dollar deficit after vilifying Barack Obama for racking up huge debts is intellectually dishonest, the libertarian senator and former presidential contender said. "*If you were against President Obama's deficits and now you are for the Republican deficits, isn't that the very definition of hypocrisy?*" he asked.

With the US heading into some of its biggest budget deficits outside of wars and recessions, and the Bipartisan Policy Center, a non-partisan think-tank, predicting that Congress will settle on plans that drive the deficit to 5.7% of US gross domestic product in 2019 (a number comparable to the shortfall after the recession of the early 1980s under Ronald Reagan, even though the US is now at or beyond full employment and the global economy is in its strongest upswing in a decade!), economists too are sounding the alarm bell. *"Having such large deficits during peaceful, strong economic times is reckless fiscal policy. We saw in 2008 how the economy can turn on a dime. If something like that were to happen in the next few years with these kinds of deficits — particularly with the ageing of the baby boomers on top of that — we'd be in a very dangerous fiscal position."* Shai Akabas of the Bipartisan Policy Center said. With the Federal Reserve reducing its holdings of US Treasuries and inflation readings starting to sparkle (the latest January US CPI reading came out on the strong side, showing a 2.1% YoY increase), some investors strongly believe that bond yields will continue to rise further in response to the heavy borrowing.

Moving to the Middle-East, the Israeli police – after 14 months of investigation - have finally decided that Prime Minister Benjamin Netanyahu is a crook (shocking!!). Still, that doesn't make him guilty, and Bibi says they are biased. Whilst he intends to fight on and do what it takes to stay in office, the police report now goes to the attorney general, Avihai Mandelblit. If he decides to indict, Netanyahu will have to step down. But that is not merely a local political situation. Netanyahu is, for better or worse, one of the world's important statesmen. On matters pertaining to the Middle East, he has been President Donald Trump's mentor, guru and partner. In some ways, his senior partner! The two men also have a common goal. Trump's key project is to reverse and wipe away every trace of the policies of his predecessor, Barack Obama, foreign as well as domestic. Netanyahu spent the eight years of the Obama administration hitting heads over what he considered to be misguided American behaviour. For Trump, all this was a menu for Obama Reversal. In short order, in consultation with Netanyahu, stopping Jewish settlement in the West Bank ceased to be a U.S. priority and Jerusalem was recognized as Israel's capital. Trump's team negotiating with the Palestinians was recruited from among American Likudniks, and leaked plans for a peace deal left the Palestinian leadership fuming. With Bibi now weakened and distracted by his legal jeopardy, the US president is surely better off finding new stable and lasting partners in the region.

More important though – both regionally and internationally - is the boiling conflict between Israel and Iran in Syria, which almost erupted last weekend into another regional war – if it wasn't for the intervention of Russian President Vladimir Putin, according to an Israeli investigative journalist. Last Saturday, an Israeli air force helicopter shot down what Israel says was an Iranian drone launched from the Tiyas Military Airbase in central Syria by Iran's Islamic Revolutionary Guard Corps. The drone was shot down a minute and a half after entering Israeli airspace, the investigative journalist, Ronen Bergman, wrote in an op-ed article in The New York Times earlier this week. Israel responded by sending eight F-16 fighter jets into Syria to destroy the drone's command-and-control centre. While flying back to Israel, they came under attack from Syrian anti-aircraft missiles — one of which, an S-200, took down an F-16, forcing the pilots to eject. Israel hit back, going after Syria's air-defence system. The Israeli military says it hit multiple Syrian and Iranian targets. *"The response to the downing of the Israeli jet was intended to be a lot more violent,"* Bergman wrote, adding that Israeli generals brought out plans *"for a huge offensive operation in Syria."* But a *"furious phone call"* from Russian President Vladimir Putin, whose forces in Syria were close by, *"was enough to make Prime Minister Benjamin Netanyahu of Israel cancel the plans,"* Bergman wrote.

With recent actions likely to increase tensions in the Middle East, and US president Trump too busy tweeting about the need to Drain the Swamp and End the Witch Hunt, one can hope that Comrade Putin will always be around to save the day!!

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.