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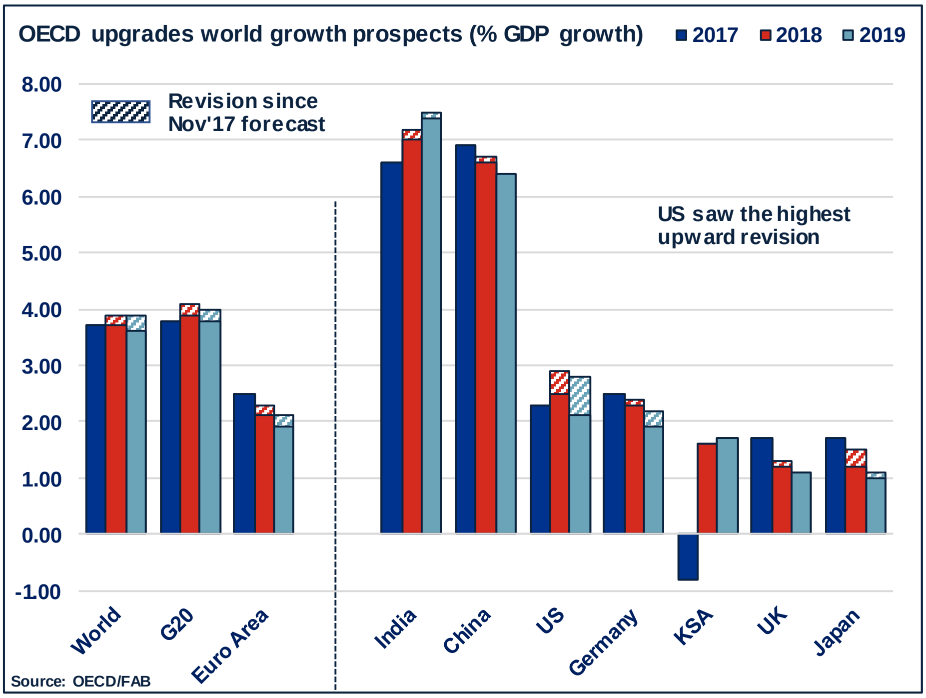
Market Insights & Strategy
Global Markets

Balancing Politics with Macro and Rates

The timing of Donald Trump's sacking of Secretary of State Rex Tillerson – replacing him with CIA director Mike Pompeo – just as the market is focusing on the challenges of the proposed meeting between the US president and Kim Jong-un of North Korea, could likely prove to be an added element to near-term market uncertainty and volatility. We would also expect the divergence between US and European metals (iron/steel) sectors to see further near-term widening as the Tillerson/Pompeo switch fuels a more aggressive US protectionist policy on trade, and an increased risk of tariffs and trade wars is priced in.

This political noise will also tend to overshadow any positive sentiment that might otherwise have been seen from yesterday's upgrade by the OECD of its global economic growth forecast. Paradoxically, the Paris-based group cited the positive momentum from US tax cuts, alongside new fiscal stimulus in Germany, as a key element of its growth upgrade. The global economy is now forecast by the agency to expand 3.9% this year and next, potentially the most robust growth since 2011; in November it forecast 3.7% and 3.6% growth for 2018 and 2019 respectively.



Note, however, that the Group also acknowledged rising tensions around the globe that could undermine strong and sustainable growth expectations going forward, not least of which could be the prospect of steady monetary tightening. We remain of the opinion that in the context of tightening labor markets, a more aggressive path of interest rate normalization could trigger disruption across a high debt/leverage, inflated asset price environment.

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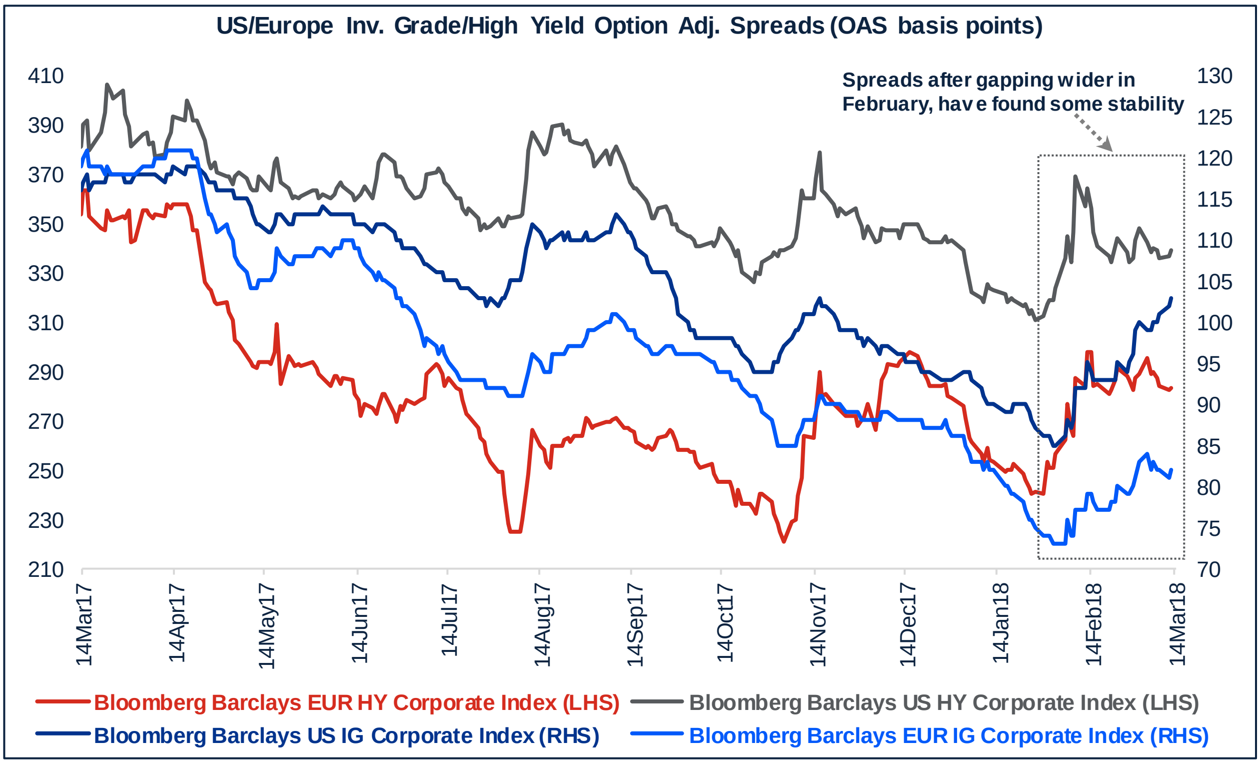
Moreover, while market consensus, through futures pricing, still indicates an expected 3 further interest rate increases from the Federal Reserve this year, beginning at next week's FOMC meeting, the OECD shows a slightly more hawkish medium-term bias. In its latest Interim Economic Outlook, it forecasts that the Fed funds rate could touch 3.25% by the end of 2019. This said, the OECD concurs with our long-held view that clear communication about the direction and velocity of rates will be essential in minimizing the risk of financial market disruptions during the tightening cycle. We believe that investors should continue to eye opportunities to hedge against future higher interest rate risks



Source: Bloomberg/FAB

For now global credit markets are adhering to a modest 'risk on' bias. Corporate bond spreads may have edged wider during February on the back of the rates market selloff, but have subsequently stabilized. That said, a push by issuers to expedite borrowing ahead of any perceived sustained rise in interest rates and debt service costs – European primary market year-to-date volume is currently running 30% behind the comparable level of 2017 according to Bloomberg – could swiftly weaken credit spreads across the quality curve. As such, in the context of all the above, the scope for renewed, meaningful credit spread tightening in the near-term now appears limited.

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