Your weekly market update

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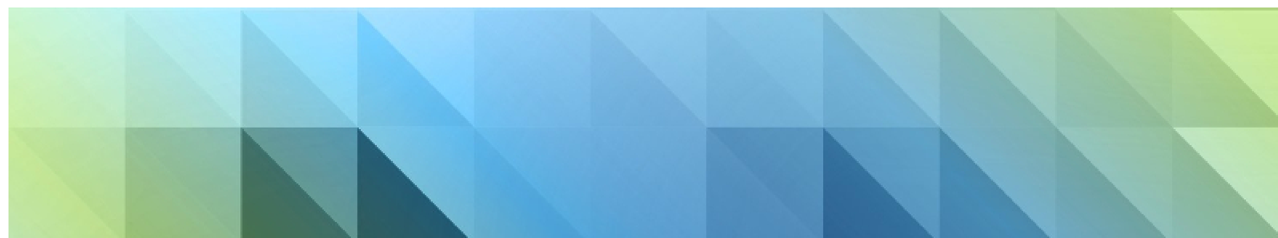

# Market Update

26 May 2017

Federal reserve chairman Janet Yellen appears to be in sync with the strategy "Taper 2.0". The Fed is holding a $4.5 trillion portfolio, known as its balance sheet. The past few days, the Fed has been telegraphing that it intends to unwind its balance sheet likely starting later in the year, raising questions on how it will impact markets. The Fed plans to set an aggressive path towards higher interest rates, one key element could scuttle this plan. Substantially lower than anticipated inflation would derail central banks in normalizing interest rates which has remained near zero since the great recession of 2008. Since December 2015, an interest rate hike by the Federal Reserve has taken place three times with most economists expecting two more rate hikes this year. It is critical that the Federal Reserve gets this right. Unwinding the $4.5 trillion balance sheet too quickly, along with aggressive rate hikes, would see a recession in the next 24 months.

The Trump administration is under attack as the President himself helps fuels his administrations demise. Treasury Secretary Mnuchin has launched his economic plan to launch fiscal stimulus. On Thursday, Mnuchin stated he expects to see a bipartisan buy in. I myself just don't see this unfolding. The Democratic party and a strong centre of Republicans see Trump's presidency as a lame duck leadership. How do you overcome such a bipartisan force as Trump's own hand is damaging him and his administration?

Prime Minister May and her party have made a colossal error with Brexit. Expect to see the factor of the United Kingdom with Scotland ready and poised to leave the Kingdom and retain EU

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membership. For the investment world, Brexit has been a God sent as assets have been discounted dramatically along with a deeply devalued pound sterling.  Given that this is just the beginning for Britain as it plans to leave the Union, expect to see the currency come under attack. The G7 summit in Sicily is already showing division among global leadership. The President has openly attacked Germany about car sales in America, be it tweets or public statements - it never ends.

Oil prices edged higher Friday as investors were tempted back to a market that tumbled 5% in the previous session on disappointment that an OPEC led decisions to extend current production curbs did not go deeper. Yesterday's meeting in Vienna, the Organization of the Petroleum Exporting Countries and some non-OPEC producers agreed to extend a pledge to cut around 1.8 million barrels per day until the end of the first quarter of 2018. The initial agreement would have expired next month. Producers are confident of this plan bringing down crude oil stocks to their five-year average of 2.7 billion barrels but oil investors had hoped for a last-minute agreement on more far-reaching action. The problem is that investors look at impact today, while OPEC focuses on reaching stability in the coming 9 months.

Clawing back some of Thursday's losses, global benchmark Brent futures were up 28 cents at $51.74 a barrel at 0837 GMT. West Texas Intermediate (WTI) crude futures remained below $50, at $49.11, though up 21 cents from their last close. Concerns remain that OPEC led production cuts will support a further rise in output from the United States, where producers can operate at much lower costs. Vienna's meeting sends a signal of continued support for oil prices from OPEC which helps American onshore drillers raise their production further. Oil production in America has already risen by 10% mid-2016 to over 9.3 million bpd, close to the output of top producers Russia and Saudi Arabia. With U.S. output rising steadily and OPEC and its allies potentially ramping up production in 2018 to regain lost market share, expectations are that another price slump is around the corner.

China has gone on a spending spree for 3 decades. Borrowing money to build cities, create manufacturing giants and nurture financial markets. Money that has helped drive the economic

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powerhouse in recent years. Currently, debt fuelled binge spending now threatens to sap the energy of the world's second largest economy. Chinese economy is maturing. No longer a developing nation, China has to pile on more debt to keep growth going at a pace that could prove unsustainable. Money is increasingly flowing through opaque channels that operate outside the regulated banking system, leaving China vulnerable to blowups. This is a blatant attempt by politburo leaders to camouflage the Chinese dire economic state. A true house of cards. A major credit agency sounded the alarm on Wednesday, saying the steady buildup of debt would erode China's financial strength in the years ahead. The agency, Moody's Investors Service, cut the country's debt rating, its first downgrade for the country since 1989. China's debt problems stem from the global financial crisis in 2008. As world growth faltered, China unleashed a wave of spending to build highways, airports and real estate developments. All of which kept its economic engine chugging. To finance the construction, local officials and state-run companies borrowed heavily. Even after the worst of the crisis passed, China continued to rely on debt to fund growth. Debt no longer packs the same economic punch for China. An aging work force, smaller productivity gains and the sheer math of diminishing returns mean it must borrow more money to achieve less growth. China's debt has been increasing lately by an amount equal to about 15% of the country's output each year, to keep the economy growing from 6.5% to 7%. Overall debt in China, by the same measure, barely changed from 2001 to 2008, when the country achieved some of its fastest double digit growth rates.

As a percentage of economic output, China's total debt including the government, households and businesses is now high for a developing country. It has similar levels to those of many developed Western countries, though its debt load is still considerably smaller than Japan's, according to the Institute of International Finance, a trade group of global banks. Some economists now compare China to Japan, where a lack of willingness to deal with it's deeply indebted companies has led to what is commonly called the Lost Decade, a period of sluggish economic activity there. Against that backdrop, Moody's on Wednesday lowered it's rating on China's sovereign debt by one notch, to A1 from Aa3. The move brings it in line with another

major ratings company, Fitch Ratings. A third, Standard & Poor's, rates China a notch higher but with a negative outlook, which means its next move is also likely to be downward. Moody's changed its outlook for further rating changes to stable from negative. The downgrade reflects Moody's expectation that China's financial strength will erode somewhat over the coming years, with economy wide debt continuing to rise as potential growth slows. China criticized the move within hours, saying that Moody's failed to understand China's legal or financial systems and underestimated the country's efforts to restructure its economy to achieve more sustainable growth. More broadly, experts inside and outside China believe Beijing probably has the power to stop a meltdown of the kind that slammed the United States and much of the rest of the world a decade ago, thanks to the Chinese government's considerable financial firepower and ironclad grip on the country's banking system. Economists at the International Monetary Fund have issued a series of increasingly strong warnings about the pace at which the debt is rising. China's financial system has traditionally been firmly under the control of the central government, giving many economists confidence that Chinese officials could contain a crisis of the sort that gripped the world in 2008. Still, fast growth and signs of fragility in the financial system have given pause to economists and Chinese regulators alike. Chinese corporate debt has been mounting, and China's banks show little inclination to force companies to do something about it. China's banks have kept lending to the country's state-owned companies, even to those in trouble, to help them make payments on previous loans. That helps those companies stay in business and helps the economy keep growing despite mounting debt.

The Bank of Canada held interest rates of 0.5% saying uncertainties continue to overshadow the economy's stronger-than expected start to the year. Canada's economy hasn't looked so robust since the collapse of oil prices in 2014. It's evident in gross domestic product data, job growth, retail sales and even the much maligned manufacturing sector. So, if things are so rosy in Canada, why are investors so down on the country's outlook? There are two key reasons why Canada's economy is doing better. Oil prices have rebounded from last year's lows and that's giving

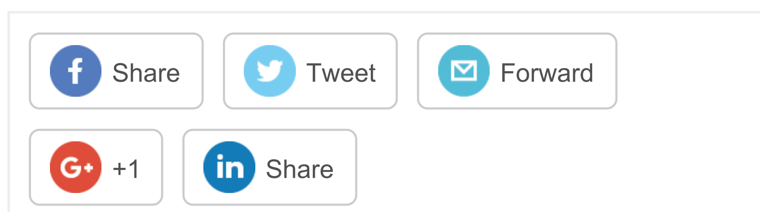
energy producing regions some life. Second, a housing boom in Vancouver and Toronto is fuelling construction and creating billions in new found wealth for the city's citizens.

The Bank of Canada is projecting output expanded at an annualized pace of 3.8% in the first quarter of this year, building off a 3.2% expansion in the second half of last year. These are heady levels of growth that are at the very high end of what Canada's economy has been able to hit in the past 15 years. It's also at the high end of growth for large rich nations. The recent employment picture has been strong. The country has had positive job gains for six straight months, and since July has added 277,000 jobs. That's almost as many jobs created as the previous two years. Other positive signs include hours worked numbers that show gains of 1.1 per cent over the past 12 months and an unemployment rate at 6.5% that is the lowest since the recession. Driven by the job gains and feeling wealthier because of rising home values, Canadian households are spending. Retail sales in the first three months of 2017 were 6.3% higher than the same quarter last year. At almost double the pace of growth only a half a year ago. These are good signs for an economy in which consumption makes up 57% of output. There are even signs of an improving picture for industrial Canada, the country's weak spot for years. Factory shipments in March were up 8.2% from a year earlier, which was the fastest year-over year pace since 2014. However, investors haven't been too impressed. The Canadian dollar is only one of two major currencies that have declined against the American dollar this year. The only country the Canadian dollar has out performed is Brazil, which is in the middle of a political crisis. In part, people are taking their cue from the Bank of Canada. Policy makers have been highlighting the risks and weakness of the economy for months, even in the face of improving data, and downplayed chances of higher interest rates as borrowing costs increase in America. This is one reason why the Canadian dollar has been weak. Interest rate differentials matter for currencies and with the American central bank in the middle of a rate hiking cycle, and rates flat in Canada, investors have found the Canadian dollar less attractive. The next rate hike in Canada isn't likely to happen until the second quarter of 2018.

The central bank's reluctance to raise rates and its analysis has raised some eyebrows, especially given Canada's economy is currently outpacing America. Poloz has been arguing that despite the recent acceleration in growth, Canada is still playing catch up to the American economy. Canada's march to full capacity was delayed by the oil price collapse, he argues, so it makes sense that growth will pick up and even exceed the rate of American expansion. But that doesn't diminish the need for lower rates.

The Governor has also been highlighting geopolitical uncertainties, and there is little evidence those are dissipating. There has been plenty for Canadians to chew over in the past week, including the start of the 90 day consultation period to renegotiate the North American Free Trade Agreement and a new spat with America over aerospace manufacturing. The faster-than expected growth in 2017, meanwhile, reflects temporary factors that won't be replicated in the future, such as faster residential investment. The housing market is also the economy's biggest source of financial stability risk, given elevated debt levels and all the trouble brewing over the situation at Home Capital Group Inc. Home-price growth slowed down in Toronto in the first two weeks of May, with sales falling 16 per cent from last year amid a rush of new listings. Plus, there is little evidence of inflation pressure, even with a pick-up in gasoline prices and the consistently elevated housing costs. The average of the central bank's three core inflation measures, which exclude volatile items like energy and are considered a better indicator of trends in prices, declined to 1.4% in April, Statistics Canada stated.

While subdued price pressures are good for consumers, they also could reflect an economy with a lot of excess capacity where companies and workers have little scope to demand price increases or wage gains. That may provide central bankers with all the fodder they need to remain cautious in their statement Wednesday.



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