Markets Struck by Moonlight

A review of the month's market-moving events across countries and asset classes.

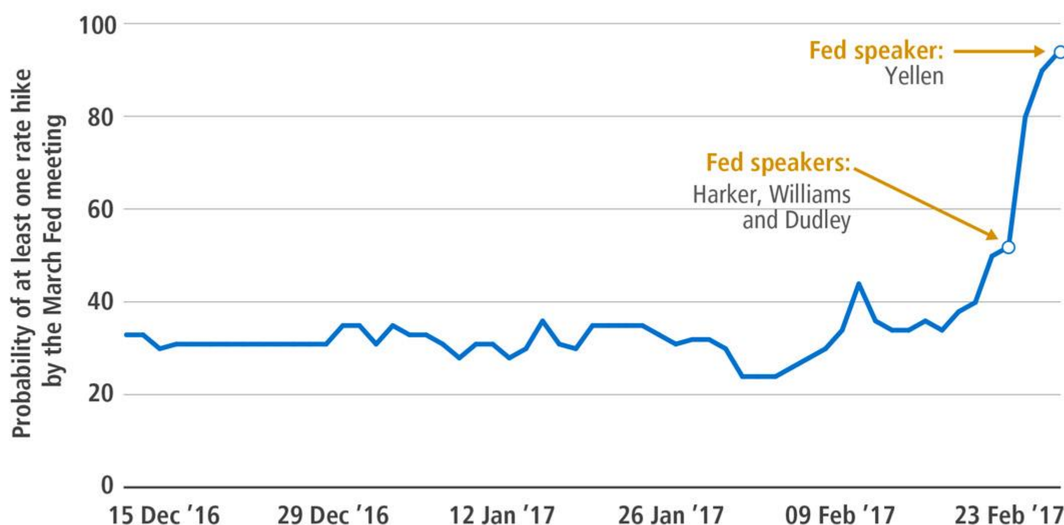
MARCH 2017

Political drama set the tone in February as investor attention turned toward Washington for glimpses of further policy detail. However, unexpected resignations in the U.S., surprises in the run-up to French elections and geopolitical flare-ups in Asia kept investors guessing.

Amid the uncertainty, anticipation grew of a possible U.S. rate hike as soon as March. In a slew of speeches, Federal Reserve officials, including Chair Janet Yellen, expressed a desire to remain ahead of the curve. No shortage of positive economic data over the month further fueled speculation, and the probability of a hike surged.

Neither the spate of political noise nor the shift in rate hike expectations over the month did much to dampen investor confidence or risk appetite. Equity markets set new highs, including 12 record days in a row for the Dow Jones Industrial Average, while emerging markets continued to outperform. In Europe, French election uncertainty sent bond spreads to highs not seen in four years.

In the world



Source: Bloomberg as of 3 March 2017

Beware the Hikes of March

Odds of a rate hike at the Fed's March meeting increased sharply over the month. While minutes from the previous meeting revealed a relatively balanced outlook, a deluge of positive economic data, along with hawkish rhetoric from Fed officials in the latter half of February boosted expectations of a forthcoming move. Although a host of voting members expressed their desire to gradually remove

additional monetary accommodation, it was comments on February 28th from San Francisco Fed President John Williams and New York Fed President William Dudley, both known to be dovish, that sent the probability soaring north of 50%. Moreover, Chair Janet Yellen reiterated a hike "would likely be appropriate" if economic progress persists. Notwithstanding a major surprise in the coming weeks, March 15 appears to be a "go."

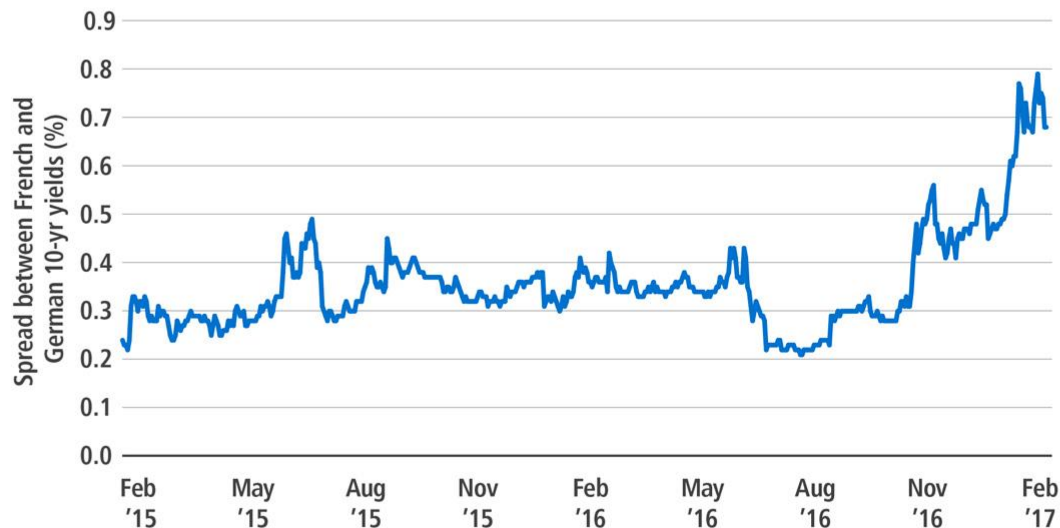
Political drama set the tone in February as investor attention turned toward Washington for glimpses of further policy detail. However, Andrew Puzder’s withdrawal as the nominee for U.S. Labor Department Secretary and the unexpected resignation of National Security Adviser Michael Flynn over his conversations with the Russian ambassador kept the news cycle focused on personnel issues. Toward the end of the month, investors fixated on President Trump’s first address to Congress, which, despite being light on policy specifics, was regarded as presidential and was generally well received as he reaffirmed commitments to pro-growth infrastructure and tax reform policies. Across the Atlantic, France found itself in an eerily familiar situation: Populist presidential candidate Marine Le Pen, previously considered an unlikely victor, continued to lead in polls heading into the first round of voting. While she still appeared likely to fall in the final round to either Francois Fillon or Emmanuel Macron, her vows to sever France from the EU and reinstate the franc were enough to drive a wedge between French and German government bond yields (see *In Sight*). Meanwhile, North Korea’s successful missile test and the purported assassination of its leader’s half-brother in Malaysia served as reminders of the increasingly uncertain geopolitical landscape.

Amid the uncertainty, anticipation grew of a possible U.S. rate hike as soon as March. In prepared remarks during Congressional testimony, Fed Chair Janet Yellen indicated an increased comfort with raising rates if economic data continued to evolve in line with expectations for gradual improvement. Her comments were interpreted as hawkish; in particular her statement that “waiting too long to remove accommodation would be unwise” suggested a desire to avoid falling behind the curve. As if to underscore her point, a raft of economic data over the month pointed to the underlying strength of the U.S. economy: Payrolls grew by 227,000, core retail sales and housing starts beat expectations, and the Philadelphia Fed Business Outlook Survey surged to its highest level since 1973. Moreover, the Consumer Price Index released in the days following Yellen’s testimony showed a year-over-year increase

of 2.5%, slightly ahead of consensus. On the last day of the month, two key Fed speakers tacitly endorsed the case for a March rate hike, propelling the probability of a hike (implied by Federal funds rate futures) from 30% to over 50%.

Neither the spate of political noise nor the shift in rate hike expectations over the month did much to dampen investor confidence or risk appetite. U.S. equities continued to set new highs, including 12 record days in a row for the Dow, as unshaken investors kept their sights on the Trump administration's plans for tax cuts, deregulation and infrastructure spending. Global equities followed a similar tune, rising for a fourth straight month as both developed and emerging market (EM) indexes gained. The latter's 9% return[5] so far in the first two months of 2017 continued to lead the pack, as EM currencies outpaced the U.S. dollar. Nonetheless, the dollar strengthened against most developed market currencies as odds of a March interest rate hike surged, and the U.S. bond yield curve flattened; two-year rates rose 6 basis points (bps), while the 10-year fell 6 bps. In Europe, election jitters about the upcoming French presidential election sent spreads between French and German government bond yields to highs not seen since 2012, as investors fretted over fresh political scandals and Le Pen's rise in the polls. And in Japan, tensions eased and the yen stabilized after Japanese Prime Minister Abe met with President Trump to reaffirm alliances and tout future job creation and investment in the U.S. It might be an exaggeration to say the markets spent the month in La La Land, but at the very least they seemed to have been struck by Moonlight.

In the markets



Source: Bloomberg as of 28 February 2017

French (Decom)Press

The spread between German and French 10-year bonds, commonly cited as a proxy for the French risk premium, spiked in the first two months of 2017, breaking out of its previously tight range and touching highs of nearly 80 bps. Much of the move can be traced to risk surrounding the upcoming French presidential election, as first-round polling leader Marine Le Pen has promised to hold a referendum on exiting the European Union if elected. This so-called "Frexit" risk has driven some investors to trim holdings of French bonds for the relative "safety" of German assets. While a victory by Le Pen in the final run-off vote still appears unlikely, recent momentum gains and stumbles by her primary opponents have placed investors on high alert.

EQUITIES

Developed market stocks[1] returned 2.8% during the month as a broad-based, Wall Street-fueled rally helped bolster international equities. U.S. stocks[2] recorded record highs in just under half of February's trading days, ending the month up 4.0% on Trump optimism and solid economic data. Stocks in Europe[3] returned 2.9% as eurozone economic sentiment rose to a nearly six-year high despite elevated political risk on the horizon. Japanese equities[4]rose slightly, ending the month up 0.5%.

Emerging market[5] stocks continued to outpace their developed-market peers, returning 3.1% as fundamentals remained healthy in select economies. Brazilian stocks[6] also rallied 3.1% based on the finance minister's forecast for a return to growth in the first quarter. Chinese stocks[7] gained 2.6% on news that provincial-level pension funds will begin investing assets in domestic equities, a move away from low-risk bank deposits and treasury bills. Indian equities[8] rose 4.0% after the government delivered a "futuristic" budget for fiscal year 2017-2018, announcing pro-growth tax cuts and infrastructure

spending. Finally, Russian equities[9] fell –8.2%, the biggest drop of any country-level index in the world, as doubt began to emerge that U.S.-Russian relations would be mended under President Trump.

DEVELOPED MARKET DEBT

Most developed market interest rates fell, recouping a portion of their losses in recent months. The U.S. proved the exception; hawkish Fed speak, strong economic releases and buoyant equity prices following President Trump's first address to Congress all combined to boost market expectations for a rate hike in March to over 80%. As a result, two-year yields rose 6 basis points (bps), and the yield curve flattened. In Europe, 10-year German bunds rallied 23 bps, while concerns over the gains in the polls for far-right French presidential candidate Marine Le Pen drove French 10-year spreads to levels not seen since the eurozone debt crisis. Meanwhile, spreads on Greek bonds tightened nearly 45 bps as the country agreed to enact some structural reforms to resume bailout negotiations. Ten-year yields in Japan rose to their highest level since the Bank Of Japan announced its yield target of around 0% last September; the bank intervened in the markets to help bring the yield back down, and it closed the month at 0.06%.

INFLATION-LINKED DEBT

Inflation-linked bonds (ILB) posted positive returns for the month but underperformed their nominal counterparts as upward momentum in global inflation expectations (break-even rates) waned. In the U.S., Treasury Inflation-Protected Securities (TIPS) and nominal Treasuries were broadly in line. The breakeven curve in the U.S. continued to flatten when a surprise to the upside in core CPI supported short-term inflation expectations. Though index-linked gilts in the UK posted positive returns, they were significantly outpaced by nominal gilts after the Bank of England's inflation report and weaker-than-expected retail prices. In Europe, risk-off sentiment amid political uncertainty in France led nominal bonds to outperform ILBs. Short-term real rates in Mexico rose as Banxico hiked rates to a seven-year high to combat inflation, while breakeven rates in Brazil continued their downward trend.

CREDIT

Global investment grade credit[10] returned 1.1% in February, with spreads tightening 2 bps in spite of falling global government bond yields. Investment grade credit benefitted from a sharp decline in

U.S. supply in February after a very heavy January, in addition to a solid corporate earnings season and generally strong high-frequency economic data.

Global high yield bond yields[11] slid to a multi-year low during February, driven by a combination of continued Trump/Congressional optimism, rising stock prices, strong earnings, plateauing Treasury yields and modest net new issuance. Yields and spreads both fell more than 20 bps, and global high yield bonds gained 1.5% for the month.

EMERGING MARKET DEBT

Investors' steady appetite for risk drove positive returns in emerging market (EM) debt in February. Spreads on external debt tightened, and index yields on local currency debt fell, as investment flows into the asset class continued apace. EM currencies continued their rally against the U.S. dollar, as U.S. Treasury yields were modestly lower. Crude oil prices were range-bound and remained supportive for oil-exporting and importing nations. Central banks in Brazil and Colombia introduced interest rate cuts against a relatively benign inflation backdrop. The Mexican peso rallied as the central bank hiked rates and announced an unconventional currency swap program in an effort to arrest the peso's depreciation against the U.S. dollar in recent months.

MORTGAGE-BACKED SECURITIES

Agency MBS[12] returned 0.48% and outperformed like-duration Treasuries by 3 bps. Although concerns about a potential reduction in the Fed's MBS holdings drove intra-month volatility, stabilizing interest rates and limited supply were supportive of the sector. Overall, conventional MBS outperformed Ginnie Mae MBS, 15-year MBS performed in line with 30-year MBS, and conventional MBS with mid-range coupons (3.5% and 4.0%) outperformed both lower-coupon and higher-coupon conventional MBS. Given higher mortgage rates, gross MBS issuance declined 29%, and prepayments fell 31%. Non-agency MBS prices were flat to moderately higher, and their spreads relative to swap rates tightened. Non-agency commercial MBS[13] returned 0.18% and underperformed like-duration Treasuries by 34 bps.

MUNICIPAL BONDS

Municipal bond prices rose during February, continuing to recover

ground from the post-election sell-off. Municipals were supported by stable interest rates, consistent inflows and below-average issuance. Lower quality credits outperformed even as several high-profile issuers were back in the headlines. Illinois appeared close to a compromise on its long-overdue budget, but voting on its 'grand bargain' stalled toward the end of the month. In other budget news, Puerto Rico's new governor, Ricardo Rossello, submitted a 10-year fiscal plan to the island's Oversight Board. The plan included optimistic growth projections and recommended a series of reforms, but largely avoided significant pension cuts or government layoffs. The federally appointed Oversight Board will have the final authority to approve the fiscal plan.

CURRENCIES

February was quieter than recent months for global currencies. Hawkish comments from the Fed and higher-than-expected U.S. inflation strengthened investors' conviction in a March rate hike and boosted the dollar against other G10 currencies. The British pound weakened as the Bank of England left rates unchanged; rumors of a future Scottish independence referendum and weak economic data also weighed on sterling. The euro fell slightly as the odds of a victory by Marine Le Pen in the French presidential election crept higher. Among EM currencies, the Mexican peso rallied when the central bank of Mexico hiked rates again and announced a new intervention mechanism designed to arrest the currency's sharp fall. Monetary tightening in Turkey boosted short-term yields and drew fresh capital flows, strengthening the lira.

COMMODITIES

Broad commodity indexes were incrementally positive for the month: The metals sectors supported performance, while energy and agriculture detracted from it. In precious metals, gold was supported by somewhat lower real yields and investor demand for hedges in case the Trump trade begins losing steam. Nickel led gains in industrial metals, supported by looming mine closures in the Philippines. In energy, natural gas was once again a notable underperformer given the very warm U.S. winter. Crude oil posted marginal gains, in part supported by a bullish report from the International Energy Agency that noted strong demand and good compliance by OPEC on its November production agreement. Overall, investors' attention remained fixed on OPEC discipline and

its intentions after May (i.e., whether to extend the six-month deal). Select agricultural commodities gained, including wheat and corn, but larger losses in sugar and coffee took the overall sector into negative territory.

Outlook

PIMCO's baseline forecast for 2017 calls for real global growth to remain in the 2.5%–3.0% range that has held for the past five years. Headline inflation should pick up in developed market economies while high inflation in emerging economies like Brazil and Russia is likely to ebb significantly. However, in light of significant political and policy uncertainty ahead, we recognize that both left- and right-tail risks have increased. In our baseline scenario, the economic expansion, now already in its eighth year, becomes the third-longest in postwar history in March and stays alive during the remainder of 2017. We assume that three transitions will progress in a relatively orderly fashion: Fiscal policy will become supportive, including a package in the U.S. that could take effect from October for fiscal year 2018; central banks will largely maintain their stimulus, thus limiting the rise in bond yields; and a full-blown trade war will be avoided.

In the U.S., we see growth above-trend at 2%–2.5% in 2017,higher than 2016's 1.6% estimate, but in line with the two years prior. We expect business investment to snap back, helped by higher energy prices and more clarity on corporate tax reform under the new Trump administration. Consumer spending is likely to be supported by further job gains, rising wages and expectations of personal income tax cuts. Headline CPI inflation should rise to converge with core inflation above 2%, and we expect the Federal Reserve to raise interest rates two or three times during 2017 (with risks to the upside).

For the eurozone, we expect growth will hover in a 1%–1.5% range as political uncertainty remains elevated ahead of crucial elections in France, Germany, the Netherlands and, potentially, Italy. Headline inflation should be above 1%, but core inflation is unlikely to make much headway toward the European Central Bank's (ECB) objective of below but close to 2%. In the U.K., we expect growth to slow to 0.75%–1.5%, reflecting fairly robust momentum tempered by the ongoing uncertainty over Brexit; inflation should exceed the

2% target, inducing the Bank of England to keep policy rates unchanged and complete its existing quantitative easing program and then do no more.

In Japan, fiscal stimulus and recent yen weakening should propel GDP growth to 0.75%–1.25% in 2017 while inflation remains significantly below the 2% target. The Bank of Japan is likely to keep to its new yield-curve targeting framework, including the 10-year at about 0%, thus continuing its standing invitation to the government to engage in more fiscal policy. We think the invitation will be accepted during 2017.

For China, we expect growth to slow to a 6%–6.5% band in 2017 as policymakers prioritize financial stability over economic stimulus ahead of the 19th National Party Congress in the fourth quarter. China's public sector credit bubble and private sector capital outflows should remain under control. We think any trade war with the U.S. will involve words rather than action and the yuan will depreciate gradually by about 7% against the U.S. dollar.

In emerging markets, we expect moderate growth will return to Brazil and Russia as their deep recessions end. With inflation dropping, both countries' central banks could cut rates multiple times. Mexico's Banxico is expected to tighten policy, following the Fed's lead, and growth should slow to 1.75%–2.25%.

In sight

LE PEN IS MIGHTIER?

Although the majority of French voters do not currently support far-right presidential candidate Marine Le Pen, her likely opponents have become more vulnerable, raising the risk of a surprise Le Pen victory. Recent polls indicated that she could receive nearly 30% of votes in the first election round in April, which would likely pit her against either Francois Fillon or Emmanuel Macron in the final round. Fillon, the traditional center-right candidate once seen as the favorite, is enmeshed in a corruption scandal, and while center-left opponent Macron rose in the polls after announcing an alliance with another veteran centrist, the coalition is untested and his voter base less committed than Fillon's.

Le Pen's election manifesto, released on 4 February, clearly states her intention to eject France from the euro and to call for a referendum on EU membership. She would likely fall far short of an

absolute majority in the June parliamentary elections, which would tie her hands in this regard, but her election would still spook the markets. Investors have already driven 10-year French and Italian government bond spreads 30 bps–40 bps higher in recent weeks to 75 bps and 195 bps over German bunds, respectively.