FINANCIAL OUTLOOK · Time for reflection in the financial markets

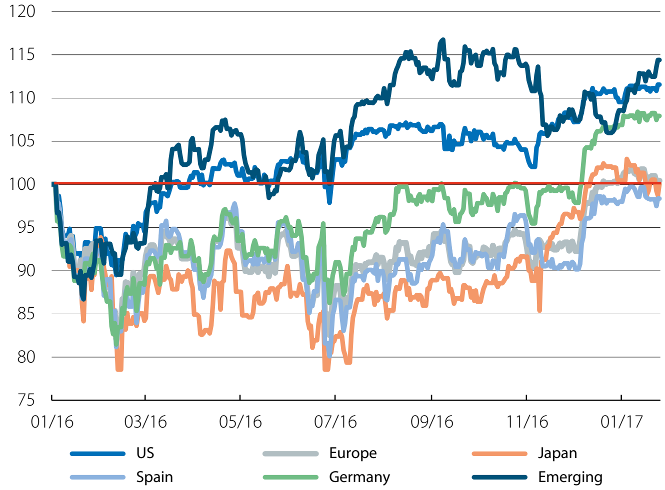
The markets are still expecting US reflation but rather more cautiously than before. The overriding theme in the markets is still US reflation; i.e. higher growth but also higher inflation, as a result of economic policy that will prioritise fiscal stimulus. Nevertheless, after the strong gains in risky asset prices following Donald Trump's victory, the tone was more restrained during most of January. In the first three weeks of the year the markets entered a more expectant phase but the perceived risk did not alter too much, as evidenced by volatility remaining at an all-time low in the US stock market in January. This seemed logical given the lack of any defined agenda from Trump and, from a strictly market point of view, the gains made just after the elections. But the rally continued, almost simultaneously with Trump taking over the White House. Such gains may not be as strong as in November and December but the underlying trend for risky assets is still upwards. Without doubt, this is partly due to the publication of favourable macroeconomic data showing that activity gained traction at year-end 2016. But the underlying drive seems to come from the market appreciating the positive effects of a pro-growth agenda in the US more than the negative effects.

Few new moves on the part of central banks. At its meeting on 19 January, the ECB repeated the mainstays of its monetary policy. It appreciated the recovery in activity but once again expressed doubts regarding the medium-term recovery in inflation (although inflation is expected to rise in 2017 it is still far from the ECB's long-term target of 2%). The ECB stated that it will ignore any spikes in inflation due to the base effect of the slump in oil prices although it will analyse any possible indirect effects. It was therefore confirmed that, after announcing at the end of 2016 that QE would be extended up to December 2017 and purchases would be reduced to 60 billion as from April 2017, tapering will be very gradual. CaixaBank Research therefore predicts a gradual reduction of purchases in 2018 and the first refi rate hike mid-2019.

US monetary policy will take a different path. Although the Federal Reserve (Fed) did not meet in January, various comments by its representatives helped to confirm the intended path for monetary policy after the decision to raise the fed funds rate last December, at a time when the reference rate was at 0.50%-0.75%. The messages provided by various Fed members in January suggest the US central bank is still monitoring any potential inflationary effects of the fiscal stimulus announced in an economy that is almost at full employment. From such messages, and from the hawkish tone accompanying December's hike, we can infer that monetary conditions are likely to get tougher in 2017 at a slightly faster rate than the market is currently expecting.

Main international stock markets

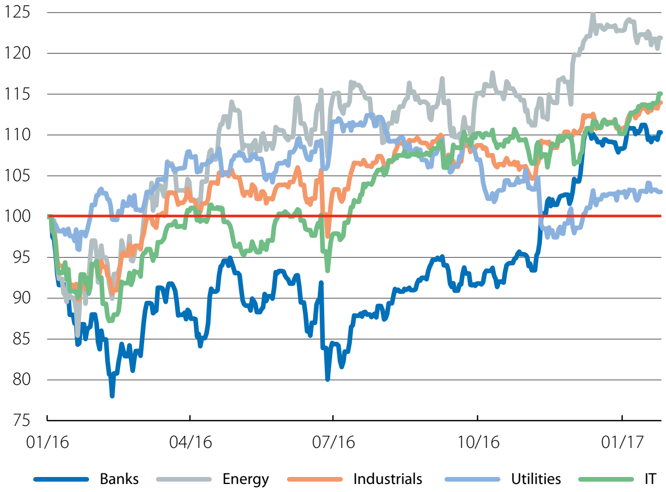
Index (100 = January 2016)



Source: *CaixaBank Research, based on Bloomberg data.*

Global stock market: trend by sector

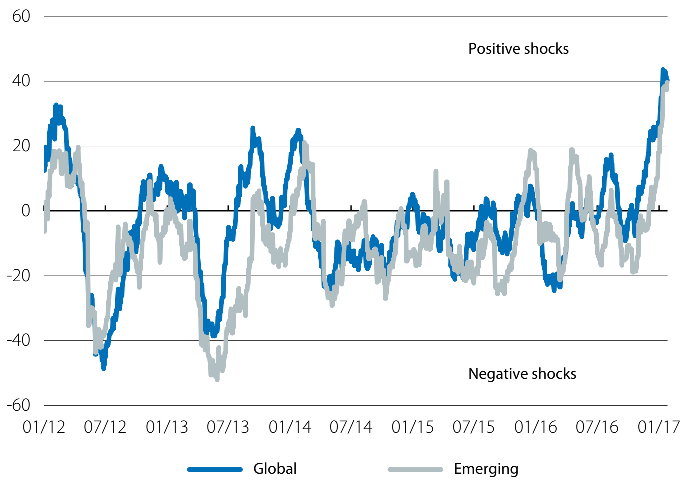
Index (100 = January 2016)



Source: *CaixaBank Research, based on Bloomberg data.*

Index of economic shocks

Level



Source: *CaixaBank Research, based on Bloomberg data.*

In line with this interpretation, CaixaBank Research predicts three hikes of the fed funds rate in 2017, while the market, apparently not very sensitive to the risks of US fiscal expansion, only expects two.

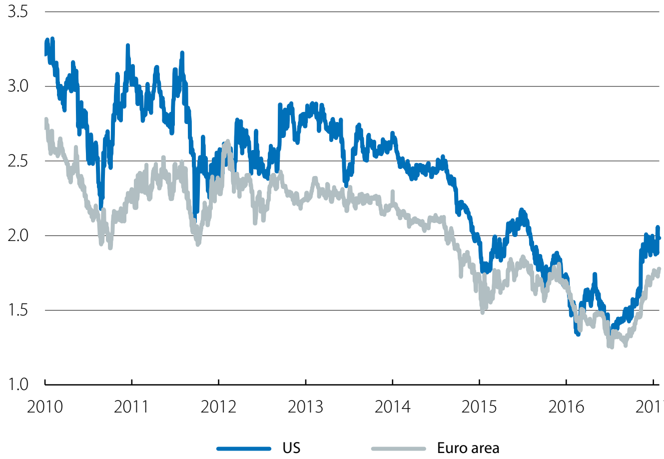
Yields on US Treasury bonds are starting to reflect more nuances related to reflation. In January, the yields on US 10-year bonds clearly reflected the uncertainty still hovering over the specifics of Trump's agenda and therefore its effects. After the upswing in yields between November and mid-December, investors shed some of their Treasury positions during the first few weeks of this year. Nonetheless, and as is also the case with US risky assets, yields spiked again towards the end of January. The net outcome of these fluctuations is a minimal rise in US Treasury bond yields during the month. It is not clear how long this relatively indecisive phase will last. It will probably be determined by how quickly Trump's administration reveals its intentions regarding government spending, taxation and trade policy and the economic effects of this new economic policy will also help to dispel doubts. It will therefore be vital to monitor price and wage indicators, given their increasingly strong upward trend, particularly in an environment of almost full employment.

Europe's sovereign debt moves away slightly from the US financial scenario. The trend in yields on the German bund in January was rather different from its US peer. While the rise in yield was minimal for the latter, the long-term German bond yield increased more substantially. Euro area sovereign debt interest rates saw two distinct stages in January. The ECB met in the first part of the month and, as already mentioned, did not announce any new moves. It merely confirmed that it would keep its monetary policy accommodative until the end of 2017. The German curve therefore remained stable while the spreads of other countries' sovereign debt narrowed with Germany. However, in the second half of the month the international markets reacted to the first moves taken by Trump's administration, with upswings in interest rates. Moreover, after December's higher inflation figure was announced, those ECB members less in favour of unconventional policies adopted a rather more aggressive public stance. This reversed the situation of the first half of the month, with rising German rates and wider spreads with the rest of the countries.

The foreign exchange market reflects investor doubts. The world's benchmark currency, the dollar, depreciated slightly, both against the euro and also in nominal effective terms (i.e. compared with the basket of currencies of its trading partners). CaixaBank Research believes this is a temporary change in trend that only minimally reverses the fast appreciation of the dollar over the past months. Unlike this technical correction, and given the diverging monetary policy stances of the ECB and Fed, the underlying trend will be further depreciation of the euro, which might return to its lower range of 1.05-1.10 dollars/euro or even break through this barrier temporarily.

*Inflation expectations: * US and euro area*

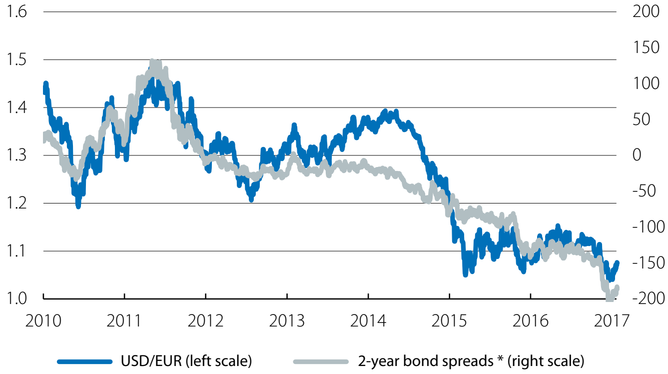
(%)



Note: ** 5Y5Y Inflation Swap Forward.*
Source: *CaixaBank Research, based on Bloomberg data.*

Dollar-euro exchange rate and 2-year bond yield spreads

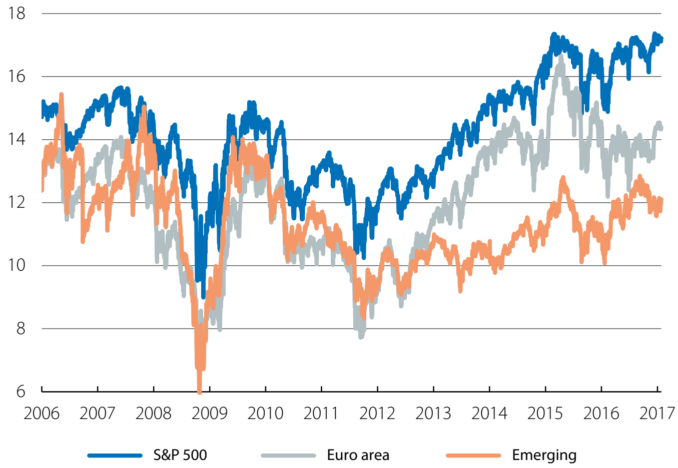
(Dollars per euro) *(bps)*



Note: ** Spread between the 2-year German bund and US Treasury bond.*
Source: *CaixaBank Research, based on Bloomberg data.*

*Regional stock markets: price-to-earnings ratio **

(PER)



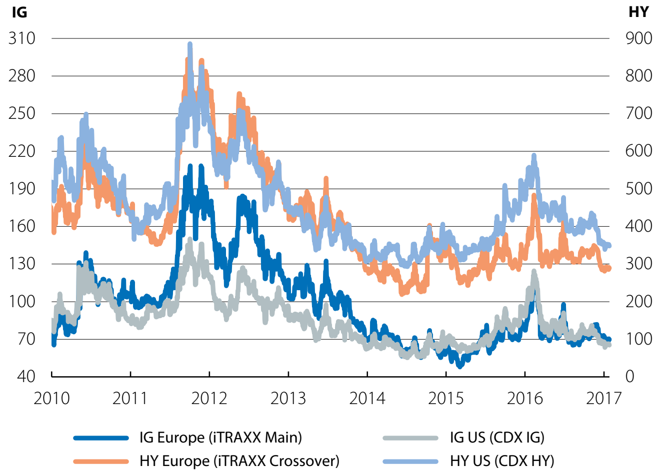
Note: ** Forward PER for the next 12 months.*
Source: *CaixaBank Research, based on Bloomberg data.*

The emerging currencies are gaining speed. As a whole, the emerging currencies were hit hard by the US presidential elections (in November, the J. P. Morgan index for emerging currencies fell by 4.4% against the dollar). Since then, almost half this decline has been reversed, timidly in December but more decisively in January. The Brazilian real and Russian rouble have performed particularly well against the dollar. In clear contrast, investors are discriminating between countries and punishing Mexico and particularly Turkey, whose currencies have depreciated strongly since last November. In line with this overall upward trend, emerging capital flows have continued to recover. In particular, the net portfolio capital inflows (debt and shares) for a representative group of emerging countries with a liberalised capital account (i.e. not China) show that the strong capital outflows from emerging economies following the US presidential elections have now been completely reversed.

Localised stock market gains and losses. The equity market is another of the segments digesting the different elements emerging from the current financial situation (namely the recent strong momentum, reflation theme and lack of economic policy specifics in the US). Although the record level achieved by the Dow Jones index on 26 January (above the psychological barrier of 20,000 points) was widely reported in the media, the trend in the US stock market has actually been more restrained. After growing by more than 3% in December, the Dow Jones index rose by a mere 0.5% in January. The more representative index of the US equity market, the S&P 500, was rather more dynamic and increased by 1.8%. Europe has been moving in a different direction. In January, the Eurostoxx 50 lost 1.8% of its value. However, this loss should be interpreted within the overall trend in the market as the euro area's benchmark index had grown by just under 8% in December. The emerging stock markets have been boosted by increased investor confidence, as already mentioned, posting gains in excess of 5% in January.

Europe and US: CDS premia by grade

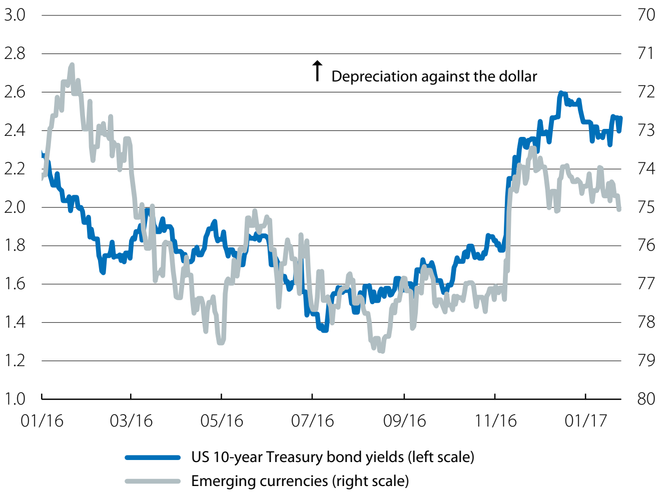
(bps)



Source: *CaixaBank Research, based on Bloomberg data.*

Emerging currencies and bonds in the US

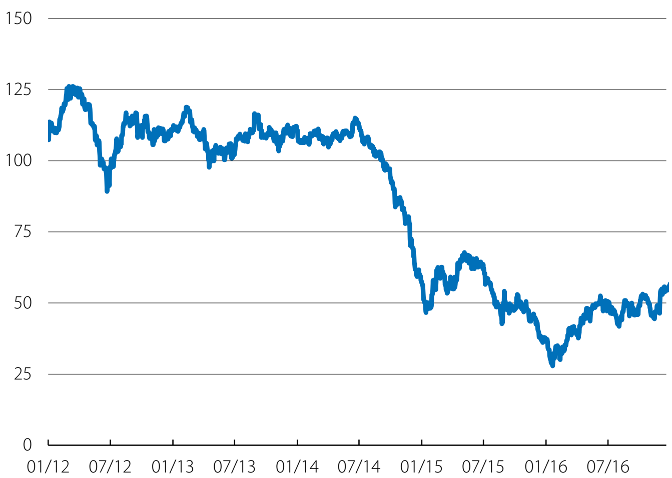
(%) *Index (100 = January 2014) inverted scale*



Source: *CaixaBank Research, based on Bloomberg data.*

Brent oil prices

(Dollars per barrel)



Source: *CaixaBank Research, based on Bloomberg data.*