FINANCIAL OUTLOOK · **A clearer political panorama provides a lifeline**

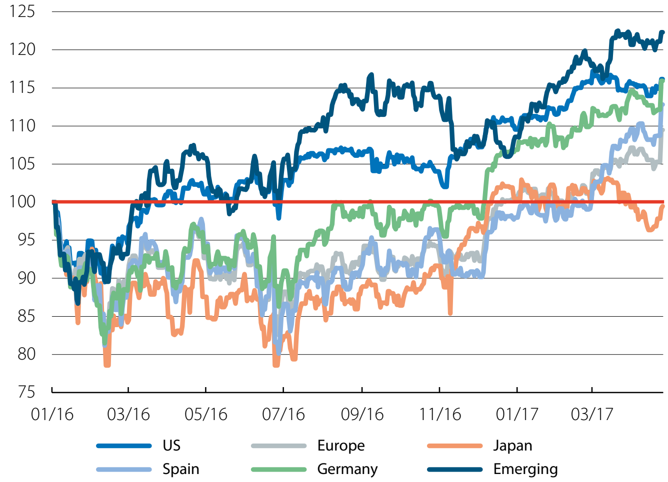
Political uncertainty sparked a period of risk-off that ended after the first round of France's presidential elections. As has tended to be the case in 2017, political risk continued to set the tone for financial markets in April. In the US, the new Trump administration had to withdraw its first proposal for healthcare reform at the end of March due to a lack of support. There are now doubts as to the new government's capacity to implement the changes it has promised. Such as tax reform, which aims to boost growth and business margins and has been widely anticipated by investors. In Europe, the announcement that the UK's general election would be held early, on 8 June, and especially the first round of France's presidential elections, kept investors on their toes. At a global level, geopolitical tension in Syria and North Korea stirred up the financial markets. A certain weakness in commodity prices also poured cold water on emerging risky assets. On the whole, all these factors led to risk-off trade in the first half of April, a repositioning of inflation expectations and investors going in search of a safe haven. This pushed up the price of gold and also of German and US bonds, reducing yields on their long-term sovereign debt. On the other hand, global equity posted moderate losses in the first part of April.

The stock markets then became more constructive in the second half of the month. Finally, as Macron and Le Pen went through to the second round of the French elections, the former in a stronger position than before, the risk-off caused by political tensions finally reversed. European stock markets rallied strongly, reversing most of the previous moves to safe havens. The yield on the US 10-year Treasury note made up a large proportion of the drop posted in April and the IRR for the German bund recovered the whole month's loss. The electoral outcome boosted the euro, appreciating by 1.85% against the dollar in the days following the election. But the markets' negative tone had already started to reverse as US macroeconomic data were published, and with the Federal Reserve's (Fed) interpretation of these in its Beige Book. These indicators still point to a market driven by global economic growth and inflation expectations on the up again. Pending more details, investors reacted with caution to the tax reform announced by Trump at the end of April.

Outbreaks of volatility gradually cool off as political threats fade. During most of April the volatility indices continued to rise, both in the US and European stock markets, due to uncertainty regarding economic policy in the US, the world's tense geopolitical situation and nervousness before France's elections. In Europe, the volatility index for the

Main international stock markets

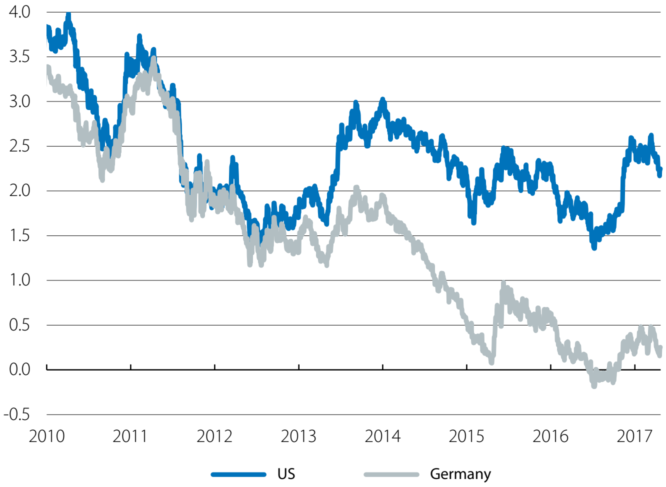
Index (100 = January 2016)



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

Yields on 10-year public debt

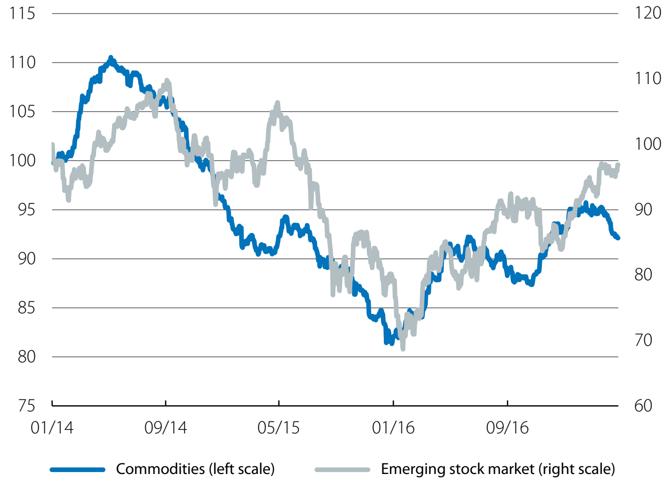
(%)



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

Emerging stock market and commodities

Index (100 = January 2014) *Index (100 = January 2014)*



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

Eurostoxx 50 (VSTOXX), which had exceeded its pre-Trump level, then plummeted to levels from the beginning of the year with the outcome of the French elections. In the US, the VIX index also dropped to its lowest level this year, now at an all-time low.

The Fed maintains its monetary policy normalisation plan despite the retreat in long-term yields. Behind the decrease in the US 10-year IRR lie factors such as inflows into US bonds as a safe haven asset, slightly weaker inflation figures (partly due to falling energy prices) and doubts as to whether reforms will actually be implemented and the extent of their impact. The interest rate futures market started to assume a pace of between two and three fed funds hikes before the end of 2018 instead of the three or four previously anticipated. But, in its Beige Book, the Fed noted that growth and wages were accelerating in various districts, which contributed to a positive reading of the macroeconomic data. This scenario has led the Fed to keep to its planned interest rate hikes, with two more announcements this year and another three in 2018, in line with the CaixaBank Research forecasts. Given this context, the Fed's forward guidance will be crucial, also regarding their balance sheet strategy and the reinvestment of maturing assets.

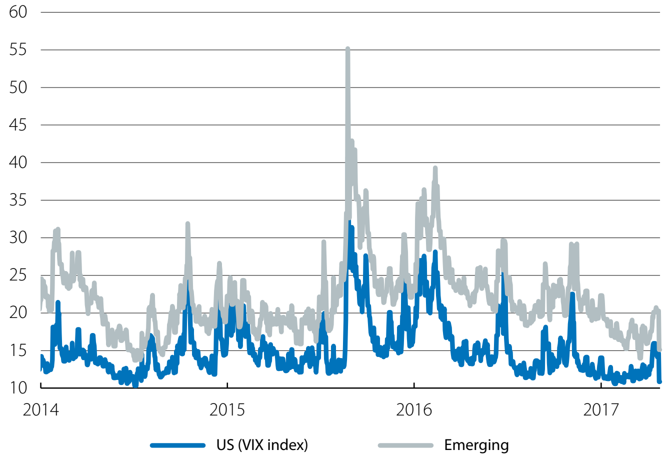
As expected, the ECB keeps the parameters of its monetary policy intact. At its meeting last 27 April, the Governing Council stated that activity indicators for the euro area still point to the recovery becoming increasingly solid and that risks are still tilted to the downside, albeit to a lesser degree. On the other hand, the slow recovery in the labour market is keeping inflationary pressure subdued, at least for the time being. There is also political uncertainty, which warrants caution before carrying out any slight change in monetary policy. Some members of the Governing Council have repeated their support for a sequenced approach to monetary normalisation, with the ECB not raising interest rates until net asset purchases have ended. According to the CaixaBank Research forecasts, the first hike in the euro area's refi rate will occur mid-2019.

With the decrease in political risk, equity markets once again focus on economic fundamentals. With the corporate earnings season in its late stages, the data published seem to confirm expectations of higher profits this year. The constructive tone of the past few weeks has led to forecast upgrades. These tend to assign greater potential to the euro area and emerging markets than the US, which also has notably higher valuation ratios. The Eurostoxx once again outperformed the S&P 500 in monthly terms, with banks leading the gains thanks to their greater sensitivity to the current environment, both political and financial. Portfolio flows also provided an accurate reflection of investor expectations, with outflows of US funds continuing towards European equity.

In a risk aversion climate, the appetite for bonds is pushing up the value of sovereign and corporate debt portfolios. In spite of a slight dip at the end of the month, global bond

US and emerging: implied stock market volatility

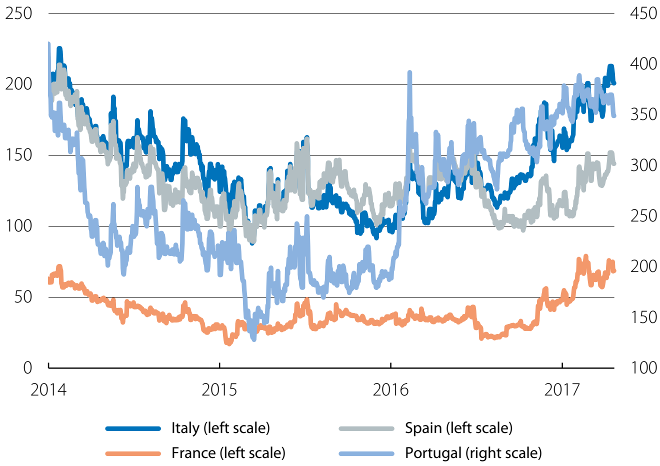
(%)



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

Euro area: risk premia on 10-year public debt

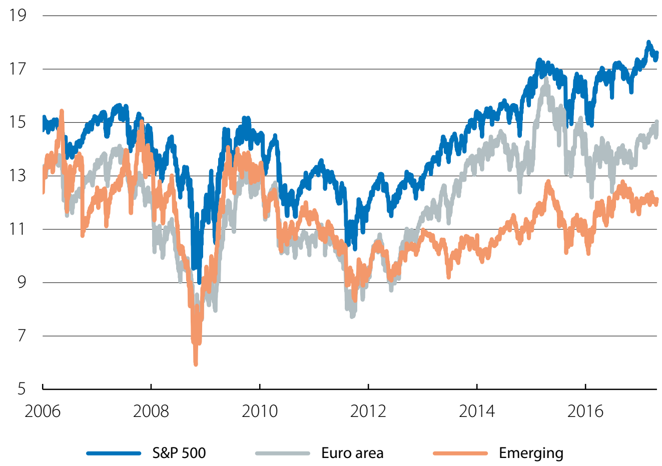
(bp) *(bp)*



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

Regional stock markets: price/earnings ratio *

(P/E ratio)



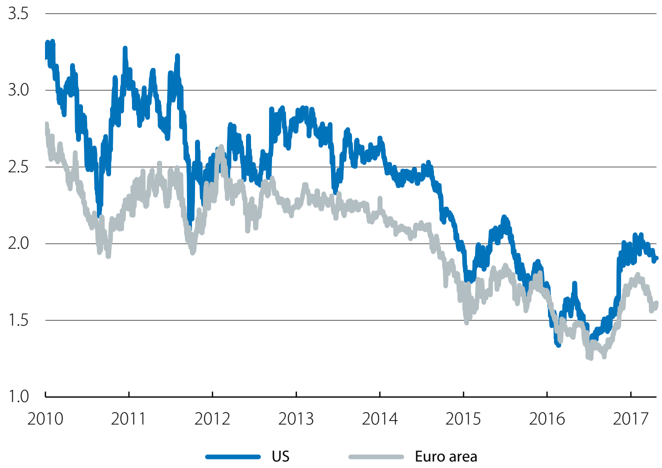
Note: * *Earnings forward twelve months.*
Source: *CaixaBank Research, based on data from Bloomberg.*

indices gained by around 1%. The largest gains were made by portfolios with longer maturities and in government debt rather than corporate debt portfolios. The drop in yields on long-term US Treasury bonds led to a slight increase in corporate spreads, especially in the high yield segment. In turn the readjustment of inflation expectations pushed down demand for inflation-protected bonds. In Europe, the drop in the yield on German 10-year bonds helped to push up sovereign risk premia during a large part of April. Corporate risk premia also picked up slightly but, as in the US, they are still quite level. We will have to wait and see how political uncertainty and the ECB's reduction in its rate of bond purchases will affect European corporate spreads.

The emerging markets also take a breather but continue to enjoy strong portfolio inflows, both in equity and bonds. The dollar's slight depreciation seems to have made the risk of emerging currencies quite attractive, pushing up demand for bonds in local currencies. But sovereign bonds are preferred over corporate, a sign that the market is concerned about the high levels of debt in the private sector. Should the positive trend continue in macroeconomic data and geopolitical tension diminish, emerging risky assets could further capitalise on their valuations, which are considerably lower than those of mature markets at present. Emerging currencies also remained relatively stable except for the South African rand and Turkish lira, the latter recovering slightly after a referendum ratifying the country's constitutional reform on 16 April. The Mexican peso performed particularly well, making up almost all the ground it lost after Trump's election. Lastly, the weakness in the main commodities also helps to explain the downturn in emerging stock markets. Continued growth in unconventional oil production has affected oil prices but drops have also spread to other commodities, such as industrial metals.

Inflation expectations*: US and euro area

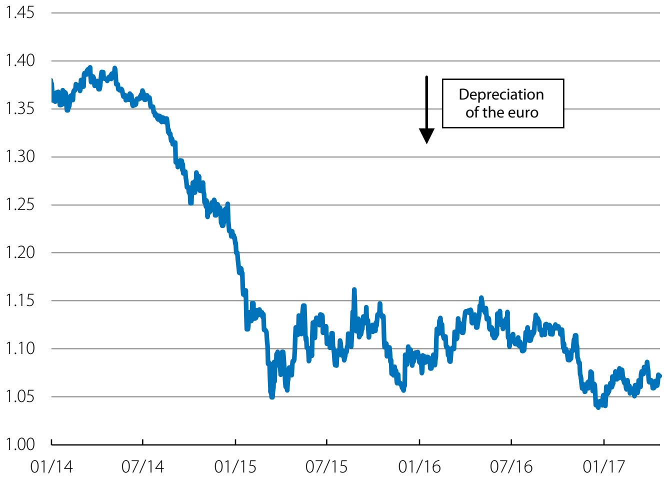
(%)



Note: * Inflation swap forward 5Y5Y.
Source: CaixaBank Research, based on data from Bloomberg.

Dollar-euro exchange rate

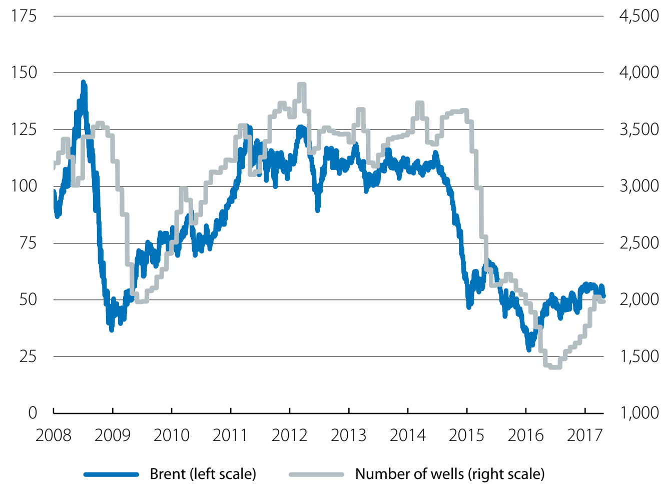
(Dollars per euro)



Source: CaixaBank Research, based on data from Bloomberg.

Oil prices and active wells

(Dollars per barrel) (Number of active wells)



Source: CaixaBank Research, based on data from Bloomberg.