FINANCIAL OUTLOOK · **Financial market gains slow down slightly**

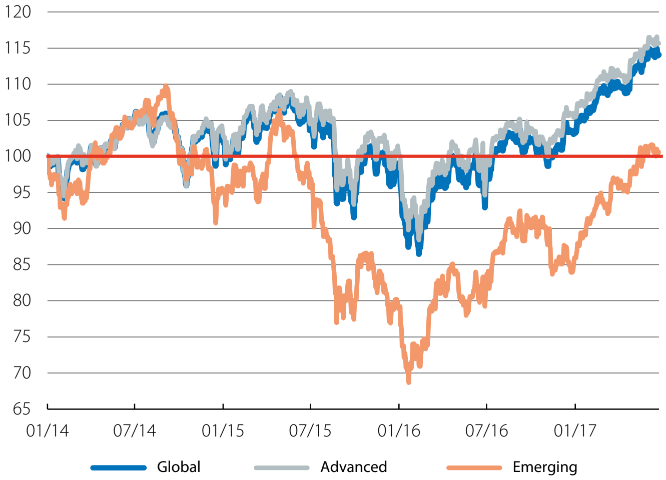
International markets have remained largely constructive although slightly less than in the past few months and with some notable exceptions. With volatility at an all-time low, the main risky assets still performed positively. The key factors behind this pause in the upward trend were lower political risk after Macron's party won the French elections and solid economic activity indicators. Neither the Fed's interest rate hike, nor its announcement that it would start reducing its balance sheet before year-end, nor weak oil prices have triggered any great alarm in the markets, at least for the time being. However, the financial sector's poor performance has acted as a brake in Europe, while the Brazilian and Russian stock markets were notably weak in the emerging bloc.

But this calm financial climate is not without its risks and sources of uncertainty. The slight slowdown in stock prices observed over the past two weeks serves as a reminder of the risks present in the global financial environment, warranting caution regarding future asset trends. Four factors will become crucial over the coming months. First, the disappearance of doubts regarding the maturity of the US economic cycle. This has been encouraged by the US's recent weak inflation figures and will be of vital importance for the US markets to remain positive. Second, high equity prices in the US, for instance with the S&P 500 achieving new record highs this month, are still a source of concern insofar as they are sensitive to any changes in investor sentiment. For example, although contained and relatively short-lived, the drop in tech stocks at the beginning of the month is a sign of the potential nervousness of investors given the high share prices. Third, the UK's negotiations to leave the EU, which started officially in June, are likely to be a source of uncertainty for Europe's markets. Fourth, the dip in oil prices in spite of OPEC's efforts to reduce the excess supply could once again become a significant source of risk, particularly for the energy industry and emerging assets.

The ECB notes the euro area's firmer economic activity and adopts a less accommodative tone. Although it has not introduced any changes to its monetary policy parameters, the ECB has acknowledged the strength of the euro area economy in the past few quarters. This could be seen in the slight upgrade made once again by the institution to its growth forecasts, used to justify a less accommodative stance in its communication. Nevertheless, the ECB is still doubtful about the medium-term recovery in inflation. Consequently its President, Mario Draghi, repeated that the asset purchase programme (QE) could be extended, if necessary. Finally, regarding monetary policy normalisation, Draghi called for caution, stating that the Governing Council had not discussed a possible reduction in the monetary authority's balance sheet.

International stock markets by region

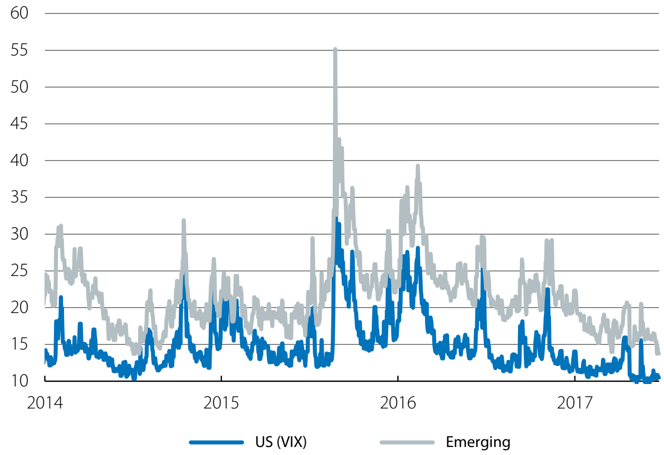
Index (100 = January 2014)



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

US and emerging: implied stock market volatility

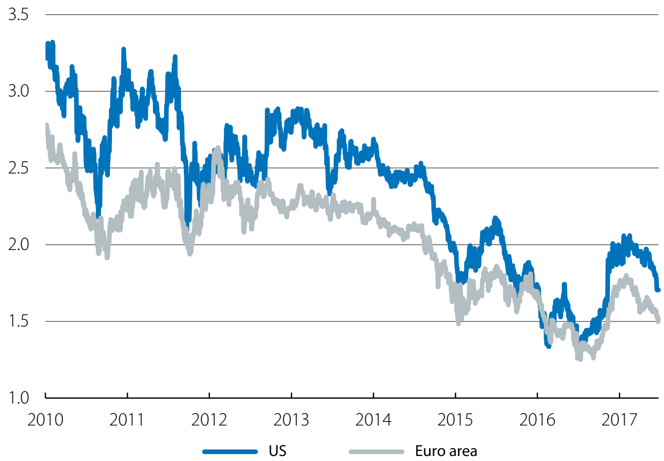
(%)



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

Inflation expectations: * US and euro area

(%)



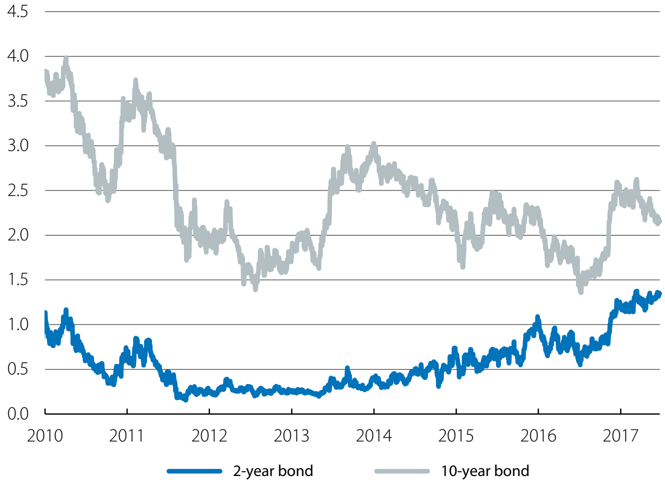
Note: ** Inflation swap forward 5Y5Y.*
Source: *CaixaBank Research, based on data from Bloomberg.*

The Fed increases the fed funds rate again and presents its strategy to reduce its balance sheet. For the third time in six months, and as the market had expected, the Fed increased the target range for the federal funds rate by 25 bp to 1.00%-1.25%. Regarding its price stability objective, the US monetary authority did not pay much attention to the recent weakness in inflation, confirming it would stick to its plan and carry out an additional hike this year and three more in 2018. Lastly, the central bank also provided details on how it was going to reduce the size of its balance sheet. Normalisation will be gradual and largely predictable although the institution did not specify when it would start the process beyond stating that it would be this year. Specifically, the Fed stated that it would stop reinvesting USD 6 billion of public debt and USD 4 billion of debt and mortgage-backed securities per month, this gradually rising over the course of a year to USD 30 billion and 20 billion respectively. Global asset markets did not react too strongly to the Fed's actions and messages.

Long-term yields on US Treasury bonds fell again while those for the German bund remained stable overall. Yield on 10-year US Treasury bonds has fallen back to 2% over the past few weeks, mainly due to doubts caused by the drop in inflationary pressures observed in recent months. Two elements will be key for long-term US Treasury bond yields to return to an upward trend. First, the capacity of Trump's government to implement their ambitious economic reforms, particularly tax reform. This will be crucial to avoid a correction in the upturn in yields observed after last November's election. Second, a recovery in inflationary pressures, which have recently looked weak, will also be vital for yields to rise again. In Europe, the yield on the German bund, which had remained stable below 0.3%, picked up strongly in the last week of June. This was in response to a speech by the ECB President. Draghi sent a message of greater confidence in the euro area's recovery, which investors interpreted as a sign of possible monetary policy adjustment in the coming months. The risk premia for most countries continued to fall, however, following a trend that started last month when political risk declined after the French elections.

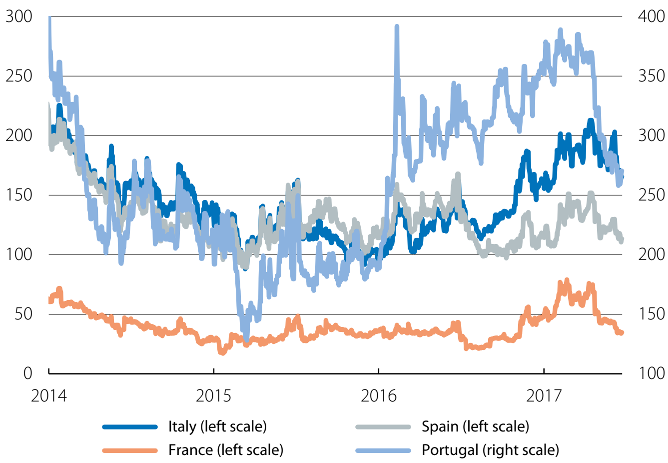
Most of the emerging countries have remained firm. The MSCI global index for the emerging stock market recorded a rise of almost 1%, slightly less than the previous month. This slowdown is largely due to the weakness of two particular markets. On the one hand, the Brazilian stock market remained weak due to yet another corruption scandal involving President Temer. On the other hand, the Russian stock market suffered large losses this month, with drops close to 5%, given fears that US sanctions will become tougher. Stock markets continued their upward trend in the rest of the markets, however, with moderate gains. In short, the relatively strong economic growth predicted for most of the emerging economies will be the main factor providing solid support for emerging assets, although weak oil prices

US: Treasury bond yields
(%)



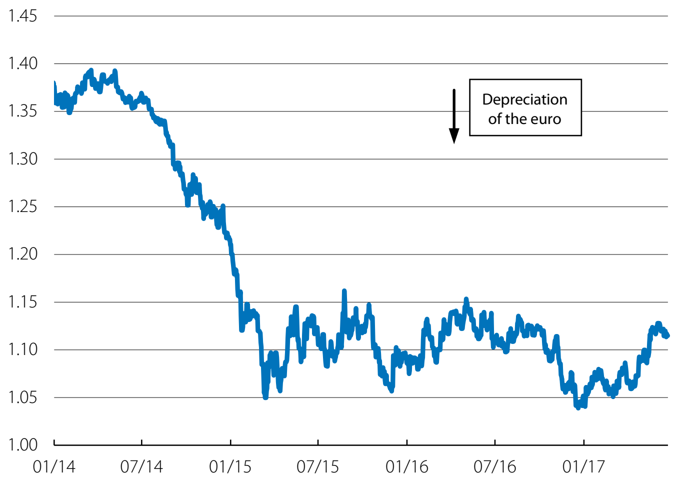
Source: CaixaBank Research, based on data from Bloomberg.

Euro area: risk premia on 10-year public debt
(bp) (bp)



Source: CaixaBank Research, based on data from Bloomberg.

Dollar-euro exchange rate
(Dollar-euro)



Source: CaixaBank Research, based on data from Bloomberg.

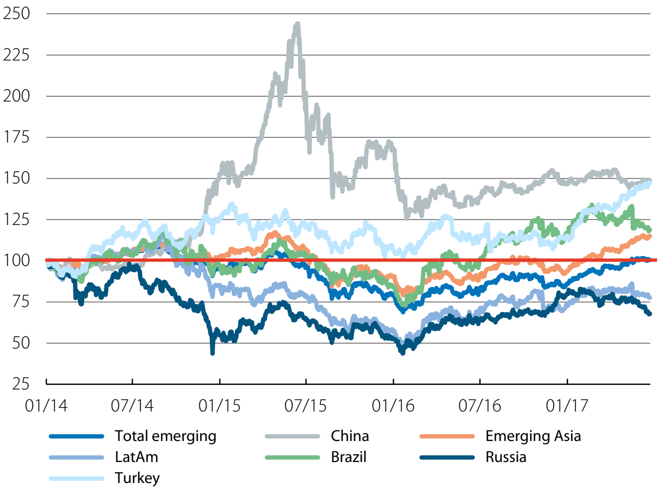
might become a significant risk factor again. In the developed bloc, while US markets remained firm in spite of a weak tech sector, most European markets suffered slight losses after the optimism shown in May. Doubts regarding the financial sector, such as the resolution of Banco Popular in Spain, were once again the main reason for this hiatus in European stock markets. The impact appears limited, however (for more details, see the Focus «The resolution of Banco Popular» in this *Monthly Report*).

The euro remains strong against the dollar in the forex market. The euro area's currency, stable at around USD 1.12 throughout the month, rose to USD 1.14 in the last week of June after the aforementioned upturn in yields on euro area public debt. We expect the euro to appreciate slightly over the medium term as the ECB begins monetary policy normalisation. In the emerging bloc, the main currencies remained relatively stable in June in spite of weak oil prices and another interest rate hike by the Fed. Affected by the same factors as the equity markets, the Brazilian real continued to lose ground against the dollar, while the hardest hit of the emerging currencies was Russian rouble.

Doubts grow regarding OPEC's ability to reduce the oil supply, resulting in a sharp slump in oil prices. In spite of the announcement at the end of May that the OPEC agreement would be extended, continuing production caps until March 2018, oil prices fell sharply again, down to their lowest level this year, with a Brent barrel costing less than USD 45. Concerns regarding excess supply are once again the main reason for this slump. The upswing in production in Nigeria and Libya, OPEC members but exempt from the cuts, particularly sparked doubts regarding the effectiveness of the oil cartel's agreement. Given the market's reaction since the agreement was extended, CaixaBank Research has slightly lowered its short-term forecasts but has kept the medium and long-term outlook the same, as we still expect a slight adjustment in the excess supply in the second half of this year. In the longer term, this effect should ease due to an upturn in production and particularly US shale production.

Emerging stock markets by region

Index (100 = January 2014)



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

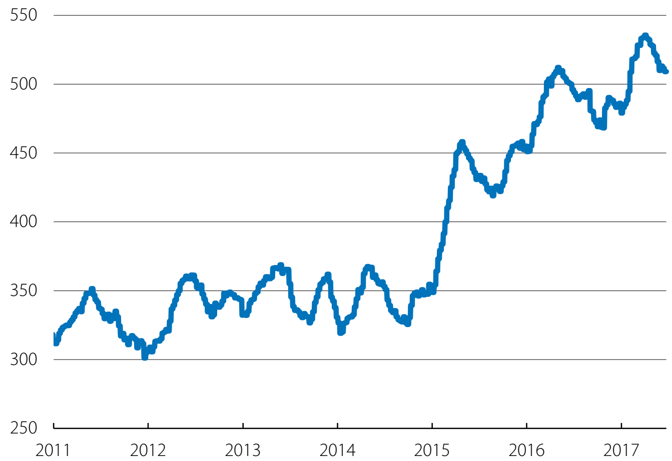
Brent oil price

(Dollars per barrel)

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

Crude stocks in the US *

(Million barrels)



Note: ** Excluding strategic reserves.*
Source: *CaixaBank Research, based on data from Bloomberg.*