FINANCIAL OUTLOOK · The financial markets enjoy a summer of calm

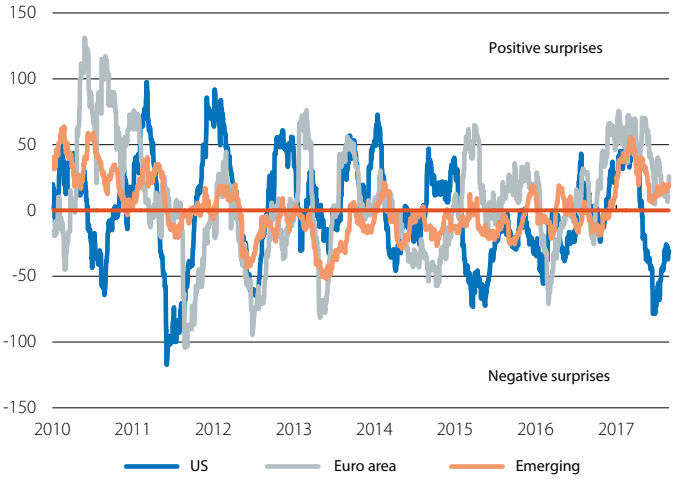
Monetary policy returns centre stage after a quiet holiday season. Global financial markets remained constructive in July and August. The world macroeconomic situation was more stable and financial volatility was low. In the advanced economies, investors are enjoying a better economic outlook owing to the euro area's increasing strength and to continuing solid growth in US economic activity. The messages issued by the US Federal Reserve (Fed) and European Central Bank (ECB) throughout July and August suggested that monetary policy would be readjusted over the coming months. The Fed will start to reduce its balance sheet via a strategy that was calmly received by investors and could begin after its September meeting. Given the improved economic scenario, in the euro area investors expect the ECB to take a less accommodative stance, gradually reducing its asset purchase programme (QE) throughout 2018. The Fed and ECB are altering their monetary policy at a time when investors have also revised upwards the macroeconomic outlook for the emerging economies.

But there are still risks, in spite of the low volatility. Volatility indicators such as the VIX (volatility in equity) and MOVE (volatility in bonds) remained very low throughout the summer except for a brief upswing in response to heightened geopolitical tension between the US and North Korea. This episode, which was resolved in August without serious consequences, reminds us that political uncertainty is still a latent risk factor. There are also doubts concerning some US macroeconomic indicators which were lower than expected. Since asset prices currently reflect such doubts, it is important for these to dissipate over the next few months to convince investors the Fed will continue its gradual normalisation of financial conditions. The high prices achieved by US equity are also a source of concern. Finally, other sources of risk are OPEC's ability to reduce the surplus oil supply and China's financial conditions.

The stock markets of the main advanced economies take a breather. The main stock markets have made significant gains since the beginning of the year, such as the S&P 500, +10.4%; Nikkei, +2.8%; FTSE 100, +4.0%; DAX, +5.0%; CAC, + 4.6% and Ibex 35, +10.1%. But they remained relatively calm during the summer months. Slightly less dynamic in June, in July the main indices were more constructive while there was relatively little trading in August. However, from the 7 to 13 of August, heightened geopolitical tension between the US and North Korea pushed up volatility, resulting in stock market losses. By region, the US stock market continues to break records while the euro area stock markets are more moderate and, in Germany specifically, the downward trend of the past few months continued.

Index of economic surprises

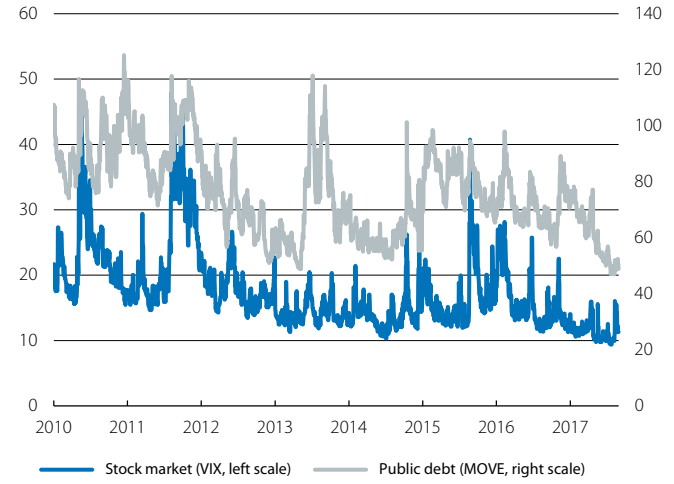
Level



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

Implied volatility in financial markets

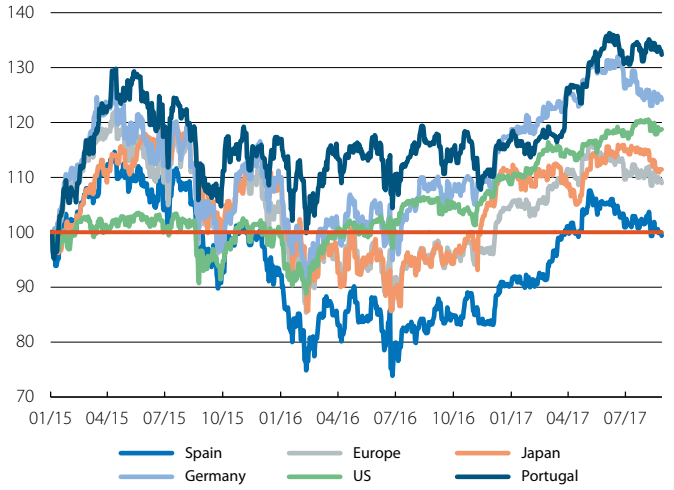
Index *Index*



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

Main advanced stock markets

Index (100 = January 2015)



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

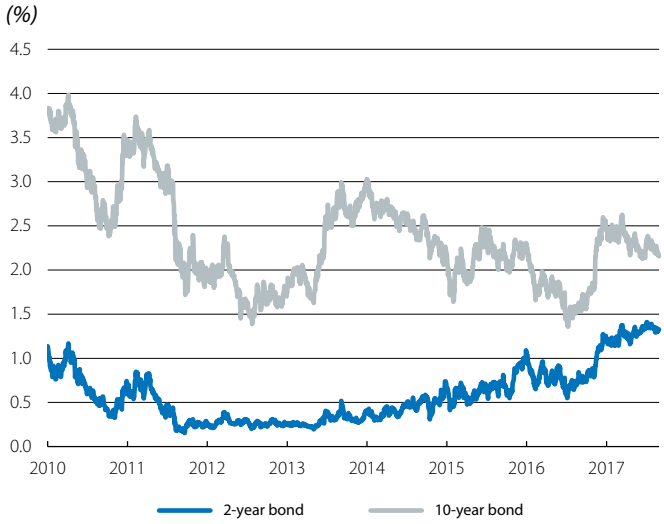
The Fed is ready to normalise its balance sheet. The messages given out by the Fed throughout the summer stressed its confidence in the outlook for the US economy and its intention to continue normalising monetary policy. At its July meeting, the Federal Open Market Committee (FOMC) maintained the fed funds interval at 1.00%-1.25%, as expected after two hikes during the first half of the year. The Fed also noted its intention to start reducing the size of its balance sheet «relatively soon». The consensus of analysts, in line with the CaixaBank Research scenario, expects the announcement to become official at the next meeting in September. The minutes of the last meeting, as well as statements by FOMC members throughout July and August, show that, in spite of some disappointing figures, the FOMC has maintained a scenario of firm growth in economic activity and a steady rise in inflation up to the 2% target. Its members therefore suggested, once again, that the fed funds rate should continue to be raised gradually over the coming quarters. Nevertheless, these messages from the Fed were contrasted, in July and August, by the downward trend in US sovereign debt premia, especially in bonds with longer maturities.

The ECB is getting ready to redesign monetary policy with greater confidence in the euro area's outlook. As expected, at its July meeting the ECB did not alter the parameters of its monetary policy, noting that QE would continue until the end of the year, as planned (net purchases totalling EUR 60 billion a month). However, both at this meeting and throughout the summer, the ECB reinforced its message of a firmer outlook for economic activity in the euro area. After improving risks to the growth scenario, the ECB's latest messages also show greater confidence in a medium-term recovery in inflation, supported by growth in economic activity and the disappearance of temporary setbacks. At the press conference after July's meeting, Draghi therefore suggested the ECB would discuss the design of monetary policy over the next few quarters during the autumn, albeit stressing that they still need to be persistent, patient and prudent. A gradual withdrawal of stimuli is therefore likely, so as not to compromise the euro area's improved economic outlook. Given these announcements, sovereign debt markets for the euro area remained positive throughout the summer and sovereign risk premia were contained.

The euro area's improved economic strength boosts the euro. Throughout the summer, the euro increased the upward trend shown over the past few months, supported by upward revisions of the euro area's macroeconomic scenario. In July and August, the euro not only reached its highest value for the past two years against the dollar (at times exceeding USD 1.20) but also reached a peak since the summer of 2014 against a basket of 19 currencies from the euro area's main trading partners.

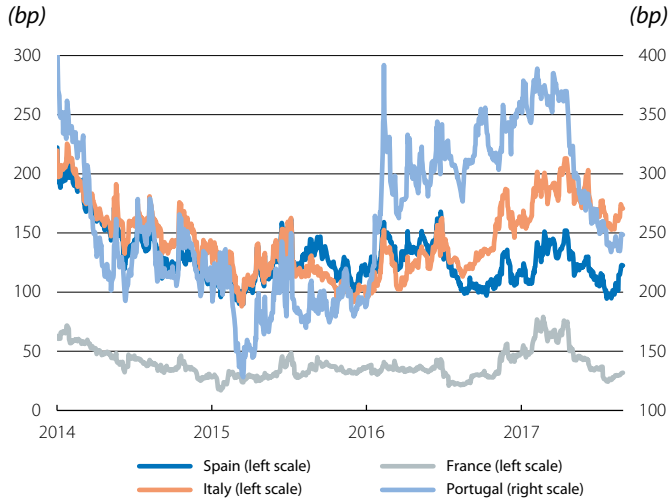
Emerging currencies remain strong. The emerging currencies appreciated slightly between July and August. Improved

US: yield on public debt



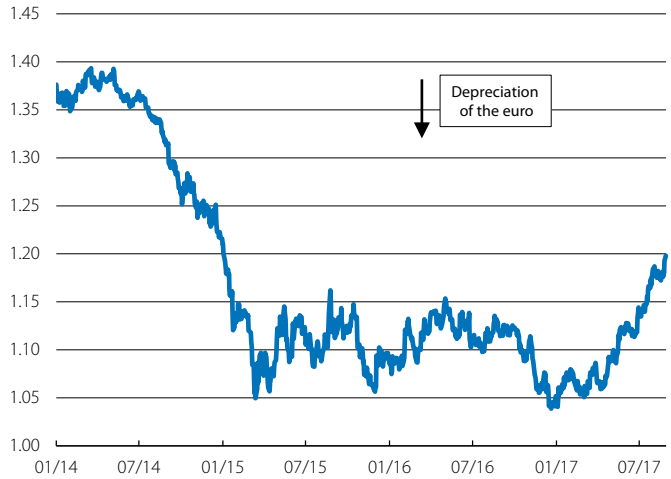
Source: *CaixaBank Research, based on data from Bloomberg.*

Euro area: risk premia on 10-year public debt



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

Dollar-euro exchange rate



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

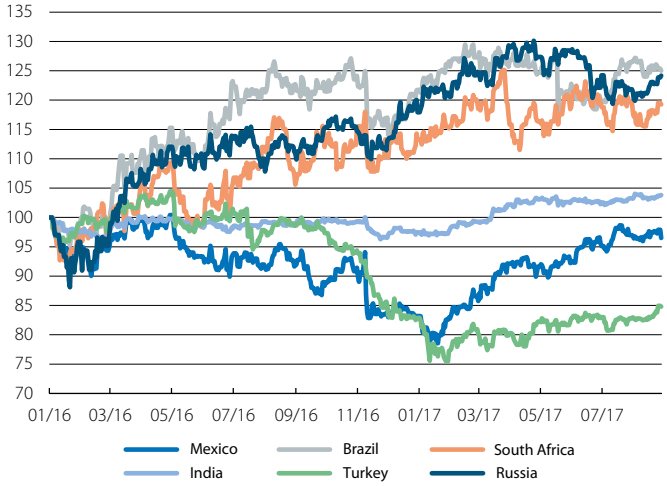
economic growth in the emerging bloc, the publication, over the past few months, of lower US indicators than expected and continuing uncertainty regarding the new US administration's agenda are helping to weaken the dollar and strengthen the currencies of the main emerging economies against the US currency. In fact, apart from the Turkish lira, they have all completely corrected the depreciation resulting from Trump's victory in the US presidential elections at the end of 2016. The Brazilian real was particularly strong over the summer, appreciating 4.4% against the dollar between July and August, boosted by positive growth in Brazilian GDP in Q2 2017 for the second consecutive quarter, meaning that the country has technically exited its recession.

Strong gains in emerging stock markets. The MSCI global index for emerging stocks was up 7.6% for July and August as a whole. The biggest gains were in Latin America and, specifically, Brazil (Ibovespa +12.6%), whose stock market was starting from a low level after the country's recent recession. The Russian stock market also made notable gains (+9.5%), another economy that has exited recession in the past few months. It was also helped by the recovery in oil prices over the summer.

Oil prices pick up and stabilise above USD 50 per barrel. Oil began the summer below USD 50, with no clear direction and looking weak because of doubts regarding OPEC's ability to cut production. However, after OPEC's last meeting at the end of July, the Brent barrel picked up and rose to around USD 52, remaining more or less at this level throughout August. The latest OPEC meeting did not change the situation regarding Libya or Nigeria, cartel members which do not come under the agreed cuts even though their production has grown considerably over the past few months. However, Saudi Arabia announced its intention to considerably reduce its exports. This announcement, together with smaller crude oil stocks in the US, helped the price of oil to recover in August and go above USD 50.

Emerging currencies against the dollar

Index (100 = January 2016)



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

Emerging stock markets by geography

Index (100 = January 2014)

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

Brent oil price

(USD per barrel)

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