NBAD

From West to East

Weekly Investment View

4th September, 2016

# The Fed has an interesting decision to make

**The S&P500 rose by just under 0.9% over the week.** Before the market opened on Friday it was announced that US Non-farm payrolls rose by 151,000 in August, below consensus expectations for an increase of 180,000. This data had been known to be important in terms of the Federal Reserve's 'data dependency', determining whether or not there is likely to be an increase in the Fed funds rate when the FOMC meets later this month. On balance, this is now deemed to be less likely, with futures markets pricing-in a 32.0% probability of a hike (down from 42.0% a week ago), with the December probability now at 59.0%, down from 64.7%. Meanwhile, elsewhere in the markets, Eurozone equities rose by just under 2% over the week, UK equities rose by 0.8% helped by good economic data, the yield on the policy-sensitive US Two-year Treasury fell by 5 basis points (to 0.7858%), and the US dollar index closed at 95.844, 0.3% higher over the week.

## *'Employment continued to trend upwards in US service sectors in August'*

**Total nonfarm payroll employment increased by 151,000 in August, compared with an average monthly gain of 204,000 over the previous 12 months, and the unemployment rate remained at 4.9% for the third month in a row, with the broader adjusted figure also static at 9.7%.** The US Bureau of Labor Statistics noted that "Employment continued to trend up in several service-providing industries". The labor force participation rate (at 62.8%) was unchanged in August. In August, average hourly earnings for all employees on private nonfarm payrolls rose by 0.1%; over the year, average hourly earnings have risen by 2.4%. The basic NPF data for June was revised down (from 292,000, to 271,000), and July was revised up, from 255,000 to 275,000, therefore combined these were about 1,000 less than previously reported. Over the last three months job gains have averaged 232,000/ month.

**So what is our take on these numbers?** Firstly, we should note there are always revisions, and also that studies have shown that this is especially true of August, whose data can be particularly volatile. Nonetheless, the numbers will be a clear disappointment for the Fed's hawks, as - taken together with last week's poor manufacturing data and the core PCE deflator staying obstinately at 1.6% vs. the Fed's inflation target of 2% - they put the Fed in rather a tight spot. Yes, they want rate 'normalization' - even if it's a few years late in coming - yet the rationale in terms of the US economy being able to cope with this is not conclusive. The annual wage growth number wasn't good, and neither was the labour participation rate, unchanged from the previous month. Manufacturing industry is having a harder time, although at least the more important services side of the US economy continues to be quite buoyant. The all-important takeaway for investors appears to be that 'lower for longer' will continue to be supportive of risk asset valuations, with a few caveats. Unless the Fed sees further deterioration in the economy, a rate hike still remains on the cards for this month.

## *'Slack economic conditions in the Eurozone warrant further ECB policy measures'*

Claude-Henri Chavanon

Managing Director
Head of Global Asset Management

**Regarding Eurozone economic statistics, unemployment came in unchanged at 10.1% for July, close to expectations of 10.0%.** Eurozone consumer inflation for July was unchanged at +0.2% year-on-year, vs. market expectations of +0.3%, while 'core' CPI fell slightly to +0.8% year-on-year, (vs. expectations of +0.9%), compared to +0.9% the previous month. The Eurozone economic confidence index fell to 103.5 in July, from 104.5 in June, and reflected widespread weakness across sectors, probably partly reflecting the Brexit vote. Following these statistics it is probably unsurprising that 82% of economists recently polled by Bloomberg expect further supportive policy measures to be initiated by the ECB at one of its upcoming meetings. Analysts expected an extension of QE beyond March, 2017, followed by a tapering of it later in the year.

**The price of West Texas Intermediate crude closed at $44.44/barrel, down 6.7% over the week.** We recently said, as WTI rallied towards $49, that we would not buy oil-related assets, and that our view of a $40-55 trading range remained intact (with $60 possible sometime during the first quarter of 2017). The market had begun to get excited about talk of OPEC production restraint coming out of this month's Algeria conference. We have viewed this sceptically, and note that most possibly interested parties have already maximized production beforehand. Iraq will now apparently support any decision by OPEC to freeze output. The situation regarding Iran is unclear; we understand they are looking to raise oil output to 4 million b/day by year-end (from about 3.8 million currently). Over in the US, crude oil and distillate inventories rose again last week, the former due to higher net imports: the EIA's weekly US Petroleum Report estimated that the amount of crude oil in commercial storage increased by 2.3 million barrels (to 525.9 million) in the previous week, much larger than the 0.9 million barrel build expected. Looking at a four-week average, US crude inventories are rising, while gasoline stocks are falling. The increase in crude oil inventories largely resulted from a large uptick in net imports, which can be very volatile, and offset a reduction in US crude output.

## *'MENA fixed income issuance is ramping up strongly'*

**Turning to MENA fixed income issuance, this has returned after the long summer holidays.** Qatar National Bank came to the market for the first time since 2013 (excluding private placement deals) with a 5-year senior unsecured $1 billion tranche that printed at 5-year midswaps +115 basis points. Also, Sharjah Islamic Bank came with a $500 million senior unsecured tranche at 5-year mid swaps +185 basis points. This week should see the NBAD 'Green bond', as well as the possibility of a 10-year benchmark bond from Emaar. Very significantly, according to Bloomberg, Saudi Arabia will likely move ahead with the sale of about $15 billion-worth of bonds in October, irrespective of whether the Fed hikes rates this month. This would follow recent successful issuance by Abu Dhabi and Qatar three or four months ago. It does sound as though the Saudis are seriously considering building-out a pipeline of debt issuance, such has been the appetite, especially from the Far East. Such a Saudi move would also provide a better backdrop for Saudi equities, which have performed poorly in recent months.

**India has been one of the main beneficiaries in emerging markets from lower commodity prices.** The Indian rupee has been resilient, while other EM currencies have begun to fall in the face of a resurgent US dollar. In Indian equities we remain neutral as per the AA view on global EM equities overall. India offers value in hard currency bonds, with spreads being offered in Indian Financials looking attractive compared to other BB+ rated names in global EM bonds. We have been bullish about the Modi initiatives towards India's energy sector. In the Indian Financials, the banks have been struggling with rising NPLs, and provisioning rising to a greater degree this year compared with last. We think this has reached its peak, however, and with more stability in NPLs the currency could see spreads improve further, particularly at the short end. This could eventually prompt upgrades if things stabilise in an unloved sector that incurred the wrath of the ratings agencies a few years ago.

## INVESTMENT SUMMARY

**We really do live in extraordinary investment times.** The IMF has just indicated that they expect to have to reduce their GDP growth assumptions once again for this year and next, although acknowledging that, for instance, the worst dangers of Brexit are unlikely to come to pass. Meanwhile, various equity markets, led by the bell-weather S&P500, continue to hover near all-time highs. Global investors have already reduced cash levels pending market uncertainties. Bank of America Merrill Lynch has reminded us that when Wall Street strategists become as pessimistic on equities as they now are (via their recommended equity vs. bond weightings), it is almost always correct to BUY equities. Their proprietary 'sell-side' indicator has an excellent track record - and certainly far better than the hapless strategists upon which their indicator is based. Then there is the factor of seasonality: the month of September has often seen downside of up to 5% in equities, and the same thing could easily happen again this year - especially if Donald Trump sees any kind of uptick in the polls, from a potentially 'oversold' position (although it looks unlikely, he *could* still win). At the same time, we have to continue to consider China, and regular readers will be aware we remain open-minded (rather than negative), despite layers of debt in organizational structures.

**As we go to print our investment strategy of being fully-diversified (although with above-average cash levels) is unchanged.** We recently took our tactical overweights in emerging market and high yield bonds down to neutral, but this was mainly to take profits in assets that looked a bit expensive and rather overbought. At the same time we left our overweight in US equities intact (and featuring an overweight in the Financials sector), countering an underweight in Eurozone equities. Our Asset Allocation Committee meets this week, and it is certain to be an interesting discussion.

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