NBAD

From West to East
Weekly Investment View
4th of December, 2016

Consolidation and correction as expected

Last week saw markets (with the exception of oil and related assets) consolidate and correct, although arguably in a sensible manner as investors continued to assimilate a flood of new information – some of which was anticipated, and some that was not. The S&P500 closed just under 1% lower over the week, with the dollar 0.7% lower in terms of its index, although with the economic big picture in the US continuing to be quite encouraging on the back of favourable third quarter growth, consumer confidence, and Non-Farm Payrolls data. Eurozone equities held up very well, given the roll-call of events falling due, with the Italian and Austrian elections being held as we go to print. Back in the US, the incoming Trump Administration continued to build out its cabinet. The market has already braced itself for a hike in the Fed funds rate this month, and is also beginning to factor-in further hikes for 2017. In summary, some of the 'Trump exuberance' evident in markets is dissipating; views into next year based on speculation and the acceptance of imprecise macro expectations are gradually being replaced by more reasonable thoughts about what lies ahead, and especially what the US President-elect and his team can and cannot achieve in the medium-term. Sure enough, political change remains a problem for investors, encapsulated by what is happening in Europe. On top of this, if Donald Trump has been having phone calls with important politicians (e.g. in Taiwan and Pakistan), these continue to add to one's understanding that the investing world is becoming more complex and especially that this US presidency really will be very different. Last but not least, OPEC last week reached an agreement to curtail its overall production, causing the oil price to close 12% ahead. **Our overall take on all the above is that we remain quite optimistic for markets, and especially for developed market equities.**

"Last week's US economic updates were impressive"

Last week's US economic statistics were very positive. The Markit Flash US Services PMI reading came in at 54.7 for November, almost unchanged from October's 54.8 and in line with expectations. Also, their Flash US Composite PMI Index (including both services and manufacturing) was unchanged at 54.9 in November. These readings demonstrate good health in the economy in the weeks either side of the US election. In other data, the Commerce Department published a report showing that third quarter GDP growth was revised upwards by 0.3% on an annualized basis, from 2.9% to 3.2%, and above expectations of 3.0%. While business investment remained a weak spot, there was further progress in the labour market, and domestic consumption was confirmed as the key factor driving growth – and significantly this was in the weeks leading up to the election. The stand-out statistic for us last week was the way US consumer confidence improved much more than had been expected last month: data from the Conference Board showed their consumer confidence index jumped to 107.1, from an upwardly-revised 100.8 in October, and vs. market estimates in the region of 101.0. Non-Farm Payrolls came in at 178,000 new jobs for November, broadly in line with estimates, and consistent with a steadily-growing economy. While we wouldn't want to infer too much from one month's data the look and feel of the US economy is indeed very positive, and represents a positive inheritance for the Trump Administration. The evidence for an elongated expansion will hopefully continue to build in the weeks and months ahead. It is probably a good thing that in practice it is likely that the planned infrastructure transformation will take longer to roll-out than appears to be assumed by the markets, as this should cause any rise in interest rates to be more orderly, and with a lower terminal rate. Stephen Mnuchin, the proposed new US Treasury Secretary, last week underlined the aspirations for the new administration of growth in the range of 3-4% going forward. **We note that the Atlanta Fed's current GDP growth forecast for the current quarter stands at 3.6%, a rate which if correct can be judged to be neither "too hot, nor too cold".**

Claude-Henri Chavanon

Managing Director
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This weekend, Italy is holding a constitutional referendum, in which the Prime Minister, Matteo Renzi, is asking voters to approve amending the constitution, transferring powers from the regions back to Rome. We are all now being conditioned to expect populism to win – and in this instance the polls are so far confirming the likelihood that Mr Renzi will lose. An important part of this is that he has been advocating a market solution to solve the significant problems of Italy's €4 trillion banking system, rather than a resolution under new 'bail-in' EU rules

that would impose losses on both equity and debt investors. Italy's banks have an estimated €360 billion of bad loans, and only about €225 billion of equity after often fraudulent lending took place against a background of low economic growth. A few of the larger banks, UniCredit and Monte Paschi, are part-way through their recapitalisation process, and market turbulence in the wake of a 'No' vote could put this at risk – in turn adding to market instability. If it's a No vote and a new government can't be formed, there will have to be a snap election. In such an election the Five Star Movement (M5S) might win a majority in the Lower House, increasing the probability of a referendum on Italy's EU membership. In the event of disorderly markets the ECB has said it might well step in with its 'Outright Monetary Transactions', subject to conditions being met by a new Italian government. Mr Renzi had originally said he would resign in the event of a No, although may now be back-tracking on this. In the world of Italian politics we have no way of knowing what might happen. In addition to what is happening in Italy, there is also another Austrian presidential election, in which Mr Norbert Hofer, of the Far-Right, and Mr Alexander Van der Bellen of the Green Party are reportedly too close to call in the polls. **There are genuine concerns about a sharp move to the far right in Eurozone politics, and with elections due in France, Germany and the Netherlands next year. For the time being, however, we still believe Eurozone equities remain good value, and that provided the currency exposure is hedged exposure should be maintained.**

"The critics of the OPEC agreement are all saying the same thing. What are they missing?"

Readers will be very well aware of OPEC reaching an apparent agreement to reduce its overall oil production from about 33.7 million barrels/day, to 32.5 mbd as of the 1st January, for at least six months, and with a possible extension to be decided on the 25th May. Within this, Saudi Arabia once again becomes the 'swing producer', taking just under a 500,000 barrel/day reduction, and with Iran, Libya and Nigeria being exempt (Iran is in effect allowed a 90,000 barrel/day increase, allowing it to approach pre-sanctions production levels). Separately, Russia has committed to reduce production by 300,000 barrels/day (having in recent months ramped-up production as much as it possibly could). The market was surprised that OPEC was able to cobble together such a deal, which had its origins in the September meeting. Certainly the price rises seen in Brent and WTI, which closed at $51.7 and $54.5 respectively, are very good news in the short-term for oil producers – including the US shale producers. So what happens now? To recap, our view at the beginning of the year was that "medium-term long positions can be put on at close to $25", within the context of a $25-45 trading range (which we then extended to $55 in mid-year), but still saying that US shale production and forward-selling would cap the upside, pending more genuine demand-led recovery being possible in 2017. As we go to print this year's NBAD Investment Outlook article on the oil markets is being written. **Following the OPEC meeting, we recommend maintaining exposures to oil and oil-related assets; while we had been looking for an opportunity to go overweight close to $40 on WTI, that chance appears to have gone away.**

Remaining with the oil discussion, in many ways the criticisms of the deal are about 95% predictable. They go along these lines: OPEC is not the force in the oil markets that it once was; shale production in the US hasn't fallen heavily as the 'market share' advocates had hoped for a few years ago, and they are becoming even more efficient; the effective policing of the agreement (based on so-called 'secondary sources' of information) is problematic; even if the recent OPEC production level of about 33.7 mbd feels accurate to many seasoned market watchers, it may have been more than this; OPEC only represents about 34% of world oil supply - and so on. **When we read such a list of criticisms we are tempted to think they are already in the market, but that other factors may not be, such as the huge reductions in capex during the last few years on the part of Big Oil, as well as the likelihood that such analyses are usually far too biased towards the supply rather than the demand side of the equation.**

"Global growth forecasts will be moving upwards in the months to follow – this is good news"

INVESTMENT SUMMARY: The investment policy of the NBAD Asset Allocation Committee remains unchanged, i.e. overweight in US (pending improvements in corporate earnings forecasts going into 2017), Eurozone, and Indian equities (the latter based on our positive medium-term view on India of a few weeks ago). We are neutral in global bonds, and underweight in cash.

Lastly, we note that the Organisation for Economic Co-operation and Development (OECD) lifted its global growth forecasts within the last few weeks to reflect a perceived shift more towards fiscal from monetary management, and especially reflecting the incoming Trump Administration. The OECD raised its global growth projection for next year to 3.3%, from 3.2%. While this is a small change these (as for the IMF) are usually made incrementally – and it's the direction of travel of such forecasts that is important. **The OECD expects growth of 3.6% for 2018.**

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