NBAD

From West to East

Weekly Investment View

10th July, 2016

A choppy week that ended very well

The major news last week was of course the very well-received US Non-Farm Payrolls (NFP) data for June, which led to the S&P500 closing up 1.5% last Friday, and up 1.3% over the week. This left the index just a point short of its all-time closing record reached in May last year (2,130.82). This level was exceeded intra-day. The index is now 0.8% above its close on the day before the Brexit vote was announced, and 4.2% ahead for the year-to-date. European equities closed firmer on Friday, but were still down 1.3% over the week; bank stocks in the region rallied from oversold positions after growing concerns earlier in the week. The Nikkei 225 closed 3.6% lower over the week, pre-NFP. The FTSE 100 index closed up 0.2% over the week, for a gain since the Brexit vote of 4%, during which time currency-driven factors have clearly outweighed political ones.

'Two-year Treasury yield summarizes the monetary scene well'

In fixed income markets, the yield on the two -year US Treasury Note closed up 3 basis points over the week, at 0.62%. The 10-year US yield fell by 3bp over the week, to 1.36%, close to a record closing low. 10-year sovereign yields in Germany, the UK and elsewhere were generally at or very close to all-time lows. These developments have been instrumental in bolstering global equity valuations. The dollar was 0.7% lower in terms of its index over the week, reflecting a more risk-on environment in the wake of the NFPs. Sterling closed a further 2.4% lower over the week vs. the dollar, at $1.2954.

US Non-Farm Payrolls rose by a very large 287,000 in June, vs. expectations averaging an increase of 175,000. Although not always a helpful guide, the private sector ADP employment figure out the previous day, which came in at 172,000 extra jobs in June, had suggested a job creation recovery in June. May's originally-posted 38,000 NFP reading, which had been something of a shock result, was revised down even further, to just 11,000, so markets had awaited the June figures hoping for a bounce back although not fully certain of one. After the announcement it was confirmed that the weather had been a negative in May, with hospitality and leisure coming back strongly in June. Healthcare and social assistance also did well, and the previously striking Verizon workers returned, having been a considerable negative in May. Looking at the three-month moving average (currently close to 140,000) is probably more instructive in a data series that has demonstrated much short-term volatility. Job gains have averaged about 175,000 in the last six months, and conventional thinking is that these need to be in excess of about 180,000 to help ensure a healthy economy. Through all this, there remains concern about a lack of qualified candidates for the job vacancies posted. Along with the NFP data came the news that average hourly earnings rose slightly in June, by 0.1%, to 2.6% year-on-year - a positive development, especially as the labour participation rate rose, causing the stated unemployment rate to rise from 4.7% to 4.9%. **As the US consumer typically provides two-thirds of US growth, such data continues to have the power to drive markets.**

'Normalization in US rates still deferred until next year'

So will one month's NFP numbers change the Fed's thinking regarding its monetary policy and rate 'normalization' in any way? In short, one wouldn't expect so. In truth, the case for the US Fed Funds rate being 'low for longer' took a small step back last week - probably only small, though, given that inflation remains very much under control according to the Fed's chosen metric, and also because inflation expectations have continued to track lower in terms of Fed 5-year break-evens. If the growth outlook continues to look stable, the Fed should be slightly less inclined to worry about dollar strength harming export competitiveness after a rate rise. With the global economy still looking fragile, however, the Fed will be increasingly mindful of the global effects of a higher Fed Funds rate if it were to act. On balance, it looks a sound judgement that the market is (according to Bloomberg) now pricing -in a 25% probability of a 25 basis point increase before the end of this year, vs. about 12% prior to the NFP announcement. **Previous QE and continued low interest rates thereafter appear to have elongated the US economic expansion way beyond normal cyclical expectations; growth in the US - currently annualizing at just under 3% - is not so high as to provide concern about over-**

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heating, yet could be high enough to enable gradual 'normalization' of rates in 2017, as long as no extra significant causes for concern arise.

Elsewhere in US data, the Non-Manufacturing (Services) ISM reading for June provided a positive surprise, coming in at 56.5 (vs. 53.3 expected, and up from 52.9 in May). The sub-readings for business activity, new orders, and employment all improved. **This positive news from the services sector augments recent supportive news in the form of good manufacturing PMI data, and adds to the potential for the US to see a long cycle.**

'German industrial production is a key metric for the EU'

German industrial production fell in May, coming in at -1.3% month-on-month, vs. expectations for a small rise of 0.1%), and April's number was revised downwards, to +0.5%, from the +0.8% posted earlier. There was weakness in manufacturing and construction, and industrial production turned negative on a year-on-year basis, by -0.4%, vs. expectations of +1.5%. **This is a very significant data point from the Eurozone,**

and provides evidence that some softening in all-important German industrial production had begun to take place prior to the Brexit vote.

During the months to come we will, like everyone else, be looking very closely as the run-up to November's US General Election unfolds. Data from Pew Research suggests that satisfaction with the US presidential candidates is running at historically very low levels. Despite the open political questions, however, the US appears to be regarded as the safest place to be in developed markets. Looking at the S&P 500, since the beginning of the year performance is being driven by sectors traditionally considered to be safe, such as utilities, telecoms and consumer staples. In a genuine bullish phase, performance leadership would need to rotate back to the higher-beta sectors, such as consumer discretionary and technology. This may eventually happen. In the meantime, investor expectations for earnings are that US companies will post their fifth consecutive year-over-year quarterly profit decline. According to FactSet, analysts are expecting corporate profits to have fallen by 5.4% for the quarter just gone. Analysts are assuming a profits recovery in the fourth quarter (of 7.2%), after a flat third quarter, yet time and time again they are proven to have been too optimistic. **Although our TAA Committee's move to an overweight position in US equities resulted from a desire to maintain the overall global equity weighting having reduced its commitment to Eurozone equities, we have been mindful that investors' cash levels are high, that short positions are under pressure, and that billions of dollars of corporate cash could be applied in M&A activity.**

'Oil prices still set fair for $60 by year-end'

Oil prices fell by just over 7% last week, following an EIA report showing that US weekly crude inventories fell less than expected, by 2.2 million barrels in the previous week, vs. expectations for a fall of 2.5 million barrels. Oil prices had their worst week since early February, with WTI trading down towards $45, and Brent at close to $46.50. Our recent expectation has been for WTI to be in a trading range of about $42-55, and still capped at close to $60 for the time being. Markets often have to consolidate in a range before proceeding to break-out decisively in a particular direction. The EIA report, showing that US crude production had fallen by less than expected is not by itself a significant bearish development. **Our expectation is that oil prices are likely to end the year in the region of $60 as the oft-quoted 'rebalancing' proceeds.**

The euro has continued to trade in a narrow range, currently close to $1.1030. The mood in the markets suggests only a small probability of an ECB rate cut on July 21st, with no meeting scheduled for August. There is the possibility of their QE being extended in September, should it be deemed necessary, following indications of contagion from Brexit. Our NBAD Global Markets colleagues have noted a market bias to sell rallies, and suggest that seeing 1.09 broken could lead to a new down-leg for the euro. TAA investment policy regarding the euro is that exposure is fully-hedged across each of the model portfolios.

'Bank of England is expected to move this week'

Turning to sterling vs. the dollar (cable), the initial shock of the Brexit vote that saw cable plummet from just below $1.50 to close to $1.31 has given way to calmer trading, but still with a bearish tone. Again, as our Global Markets specialists have said, the freezing of the various property funds was not helpful, while ratings agencies are concerned by the already large UK current account deficit, together with ongoing political uncertainty especially linked to triggering Article 50. It is a reasonable expectation that the Bank of England will cut its central rate by 25 bps during its meeting scheduled for Thursday of this week. This follows Mark Carney, the Governor of the Bank of England, warning that the financial risks of Brexit had "begun to crystalize". He said the Bank had told lenders to pause building special capital buffers, and to instead look to release as much as £150 billion in loans supportive of UK business.

Regarding the 'gating' (temporary suspension of dealing in units) of various UK open-ended commercial property funds, our assessment is that this in no way represents a crisis, or the beginning of one. Rather, it is the simple result of some weak holders thinking they could liquidate positions, with these requests coming face-to-face with the reality that real estate is an illiquid investment. Seasoned real estate investors (especially 'direct' holders) would not ever expect to be able to liquidate in the short-term. The gating of the funds by the managers concerned - apart from it being impossible to do otherwise - looks entirely logical and fair. **Real estate is a long-term asset.**

'Brexit is not the end of the world'

As far as we can tell, the global effects of Brexit will be to cause a small reduction in trade, and growth, while anything more profound will be seen in the UK alone. In the UK, it seems there is a quite high probability that an almost 'instant' recession has begun, whereas for the Eurozone the IMF last week assessed the outlook quite well, by reducing their estimate for current year growth from 1.8% to 1.7%, and for 2017 from 1.7% to 1.4%. This picture is similar to the one painted by Mario Draghi within a few days of the vote result. Growth will fall, and yes, the outlook for the Eurozone looks politically cloudier than it did a month ago. The markets' pre-Brexit assumption about Europe was that factors leading to the disintegration of the EU would at worst take effect slowly; now this has quickened to the extent that nationalism has been prodded elsewhere. Eurozone growth was already below-par, and now it looks even less impressive. As mentioned earlier, and despite the average moderate valuation (about 11x next year's earnings) accorded Eurozone equities, our TAA is underweight in this asset class. **More generally, we believe the diversified investment approach detailed in recent weeks has been justified. Our investment strategy remains essentially unchanged, pending more definitive signals from the markets.**

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