NBAD

From West to East

Weekly Investment View

14th August, 2016

Navigating the summer markets

The S&P500 was 0.05% higher over the week, closing just below Thursday's all-time closing high, while the NASDAQ Composite went to a further all-time closing high. The S&P500, the NASDAQ and the Dow Industrials indices all closed at new all-time highs last Thursday, something that had not occurred since 1999. This is frightening for some, and encouraging for others, although it does indicate a broadening of the equity market advance. If it *is* a bubble, then it's a fairly 'slow' one, with the bond markets probably more aptly accorded bubble status. This rally has been dubbed amongst the most hated for some years.

'PMs have to explain being under-invested'

Towards the end of the week came some Chinese industrial production and retail sales data that didn't meet expectations, as well as July US retail sales and producer price inflation numbers that also under-shot. These readings took the edge off what in many respects was another constructive week for many markets.

Although most of the bond market action was probably in the UK gilts market (with the UK 10-year gilt yield falling a considerable 14 basis points, to 0.50%), the benchmark US 10-year Treasury yield closed usefully lower, at 1.51%, 7.5 basis points down over the week, partly on the moderate fall in December Fed funds rate hike expectations to 42.3%, down from 46.7% the previous week. Although the US economic data points were marginally bad news, 'bearish news is bullish' as traders inferred laxer monetary conditions for longer – and as the result of what other central banks are doing. So is all this QE irresponsible? Very possibly so, ultimately, but in the meantime it's a huge weight of money.

'Emerging Market equities did well'

Japanese stocks did well over the week, with the Nikkei gaining 4.1% over the week, helped by the failure of the yen to strengthen below the 100 level vs. the dollar, the ongoing effect of Bank of Japan purchases of equity ETFs, and 'core' machine orders jumping 8.3% month-on-month June (vs. expectations for a rise of 3.2%). Eurozone stocks fell by 0.2%, despite a crop of good corporate results. In China, the Shanghai Shenzhen CSI 300 index closed up 2.8% over the week, with the FT suggesting that industrial production and retail sales there coming in below expectations had added to talk of renewed economic stimulus. The MSCI Emerging Markets equity index closed 2.8% ahead last week, as sentiment and market action was transmitted from the developed markets, and helped by some local currency strength vs. the dollar. In other asset classes, contrary to a growing bearish tone at the beginning of the week, crude oil prices rose towards the end of it by reports that OPEC and non-OPEC members would meet informally next month. WTI closed up a (quite surprising) 6.4% over the week. The dollar was 0.5% lower over the week on its index, closing at 95.72, with some market participants beginning to think that previous assumptions of sustained dollar strength for the medium-term should be questioned.

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In US economic data, July US retail sales came in flat, vs. expectations for a 0.4% rise, and 'core' US producer prices (excluding food and energy) came in at 0.7% year-on-year, down from 1.3% in June. Producer prices can influence consumer prices with a lag, so are to an extent instructive with regards to consumer price changes in the pipeline. US productivity (the hourly output per worker) registered its longest period of quarterly declines in nearly 40 years (for the third straight quarter), being down by 0.5% in the second quarter. On the positive side of the slate, US wholesale inventories rose by 0.3% in June, above the consensus estimate for no change, and compared to 0.2% in May. Readers will remember that a significant part of the weakness in second quarter GDP was a -1.4% adjustment for de-stocking, so it looks as though we can expect an upward revision under this heading. Lastly, and on a slightly different note, as Jerome Powell, Federal Reserve Board member, was quoted as saying last week, it is hard to raise rates "in a world where everyone else is cutting and demand is weak around the world". The Fed usually avoids commenting on the dollar; they are well aware that if they want to assist US growth they have to have a hidden agenda of currency depreciation. Previous dollar strength was instrumental in restraining growth during the last few years.

'Much Chinese data looks quite good'

Chinese July trade data showed imports fell 12.5% from a year earlier, and that exports fell 4.4%, resulting in a trade surplus of $52.3 billion. Imports have fallen for 21 consecutive months, while exports have fallen for 12 of the last 13 months, and the messages are clear. Consumer price inflation rose 1.8% in July year-on-year, vs. 1.9% in June, and in line with expectations. July's producer price index fell 1.7% year-on-year vs. expectations for a 2% fall. Consistent with the picture of an industrial economy slowing from a previously excellent level of growth was the news that industrial production in July was 6.0% higher year-on-year vs. 6.2% the previous month, and compared to expectations for no change in the year-on-year rate. For the same month, retail sales growth decelerated slightly, 10.2% year-on-year, from 10.6% in June, and weaker than expectations of 10.5%. Fixed asset investment growth was 8.1% in July year-on-year, a reduction from June's 9.0% rate.

The People's Bank of China (PBOC) want to increasingly use targeted monetary tools, rather than broad interest rate policy or changes to banks' reserve requirements, and to avoid over-liquefying the economy. Further rate cuts this year look unlikely. The currency is being internationalized, and will be included in the IMF's SDRs this October (delayed from last year). We suspect that such factors will now lead to a requirement for the yuan to be more stable, hence less likely to lead to capital flight. Also, as ever, MSCI (and other global investment indices) inclusion is looming, and the Chinese want to make sure this happens at the next review. Lastly, although in a real sense we will never know the answer, it is said that much progress has been made in bailing-out the shadow banking sector. Yes, China's economic transition isn't easy, but China represents a range of investment opportunities, we are taking more and more notice.

'In oil, we had hoped to 'buy cheap'

Last week the Saudi oil minister excited the markets with the possibility of OPEC and non-OPEC parties getting together next month, to discuss production restraint. Russia was quick to dismiss talk of any OPEC freeze in oil production. OPEC production restraint would, *ceteris paribus*, enable US tight oil producers to increase production, and note that the US rig count just rose again by 15, to a total of 396. From earlier this year we have assumed that global oil prices would be capped by US shale producers at about $50-55, and forward selling. Adding to the recent pressure on crude prices, EIA data last Wednesday showed a further U.S. crude inventory build, of 1.06 million b/day. Given the continuing stock overhang, we are adjusting our previous assumed WTI price range for the immediate months ahead from $42-55, to $40-50. Going into 2017 we would expect strengthening demand, led by emerging markets, to underwrite oil price recovery towards $60, basis WTI.

Egypt is very close to confirmation of a $12 billion three year loan facility with the IMF. Foreign exchange reserves are now equivalent to about three months' imports, a level that has been a marker for such help being required by emerging countries in the past. The IMF wants to make certain that its help is not just a stop-gap, and comes with sensible stipulated conditions, from a transition towards a more flexible exchange rate mechanism, further reforms (including VAT), through to the achievement of about $5 billion in external financing, so the IMF can see other solid stakeholders involved. There is still much structural work to be done to help put this important regional economy on the right track. We must hope that the loan deal is ratified.

'Gold investment demand hit a record'

The key points from last week's World Gold Council update are that the first half of this year gold saw record investment demand (of 1,064 tonnes), and that for the first time ever demand from this source exceeded that from jewellery. The dollar gold price rose by 25% during the first half of 2016. As the prices of other risk assets continue to inflate, the 'hedge' logic for holding gold is very strong, apart from the fact that we believe it continues to be in a bull market in terms of most currencies.

INVESTMENT SUMMARY:

Our investment policy remains unchanged. We are marginally overweight in Fixed Income (favouring Emerging Market and High Yield debt), overweight in US equities within an overall neutral stance in Global Equities, and are underweight in Alternative Investments (but with a neutral 'hedge' position in gold).

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