NBAD

From West to East

Weekly Investment View

15th February, 2016

Trying to make sense of it all

Investors can be forgiven for thinking that at the moment it is a rather crazy world in which we live and invest – and that this, too, is in a broad sense another leg of the 'New Normal'. Indeed, many younger investors have never witnessed such volatility, or apparent illogicality. For instance, why, when so many are worried about Japan's problems, should the yen have strengthen so much after the previous week's announcement of the Bank of Japan moving to the use of negative interest rates? We comment on this below, but the question seems a classic example of the markets serving-up a surprising result, in this instance after the latest of the major central banks' policy actions.

`Investors suffered a turbulent week, although most equity markets closed well off their lows'

Elsewhere in the markets, equities rallied well off their lows in most instances by the end of what was another fairly turbulent week. The S&P500 closed 'only' about 1.3% lower, with eurozone equities down about 4%, and Japanese equities more than 10% lower . Banks and other financial stocks were especially hard hit during the sell-off earlier in the week, reflecting investors' concerns that further moves towards negative rates (with their complications for all concerned) would likely be forthcoming, that increasing regulations are harming the whole sector, and concerns regarding the quality of earnings from investment banking operations. However, by the week's end, many bank stocks (Commerzbank was a stand-out, up 18% on Friday) had bounced strongly, as had energy and mining stocks (led by very strong oil and gold prices).

In her testimony to Congress last week, Fed Chair Yellen had the appearance of someone whose institution has received widespread criticism in recent weeks. In some respects the record is stuck, for instance when we once again hear how global economic conditions might cause the Fed to have to soften or delay its tightening bias. Just a few days earlier a story broke (whether or not garbled or untrue, we don't know) to the effect that the Fed had suggested to some banks that they include the possibility of negative rates in their stress-testing, and this story 'trended' for a while. So the Fed is up against it, and looking confused and out-of-touch. While they acknowledge that the US economy isn't doing brilliantly, they are still trying to get anyone who will listen to believe that a 2.5% average earnings increase is quite impressive. This leads into a brief discussion of the foreign exchange markets, prefaced by the probability that last week the Fed lost even more credibility in the markets – and in truth this fueled weakness in the dollar.

`Shouldn't the yen have fallen – not risen?'

Claude-Henri Chavanon

Managing Director
Head of Global Asset Management

Last week we described Japan as a 'known' Black Swan, and this leads back to our question above regarding why the yen strengthened, when intuitively investors might have expected it to weaken upon the announcement of negative rates. Now, we admit that this is all very well with the benefit of hindsight, but it seems an interesting mini-case study. One might normally have expected such a policy move (after already massive QE and growth in the size of the BoJ's balance sheet) to appear like an act of desperation almost deliberately designed to get the yen down sharply. Irrespective of the logic, the move didn't work – in fact, it back-fired very badly indeed. As an excellent article in the Daily Telegraph reminded us, Japan owns considerable overseas assets, and when Japanese investors become concerned they bring those assets home, and in size when they do so, buying yen in the process. This, superimposed on the fact (as we said last week this is a 'known' Black Swan) that the forex markets were already bearish of yen, caused short-covering. Added to this, Mrs Watanabe (who runs the family finances) is fond of being short yen and long dollars, mainly because it has worked well, so she was positioned badly. To cut a long story short, however (pun unintended), our tactical house view remains bearish of the yen vs. the US dollar.

Regarding the euro, our expert forex colleagues upstairs have reminded their readers that there remains much to be bearish about when considering the euro's prospects. The political risks of a possible Brexit appear to be growing (which other countries might want their own revised terms?), there is increasing fragility in eurozone financial institutions, the possible end of the Schengen agreement could signal an unravelling of one of the bases of the whole thesis – and that is all before we come back to the refugee crisis. We would guess that if the ECB really wanted to win any impending currency war, in very many ways they have a head. Against a current rate in the region of 1.12, our tactical allocation team remains bearish of the euro vs. the dollar. Meanwhile, we will continue to look for signs of a convincing reversal in the dollar's bullish trend.

`The global bull market in quality bonds remains intact'

The yield on German 10-year Bunds continued falling last week, to the 0.22% area, down from a recent high of about 0.55%. This, however, just takes the yield back to where it was when the ECB commenced its QE last March, so in a sense - or at least based on this particular measure - little or nothing has been achieved. Yes, in reality achieved growth (estimated to have been 1.5% last year) will have been higher than it would otherwise have been. The move downwards in yields during the last few weeks has been substantial, however, and is another version of the 'risk-off' story, as investors made a 'flight to safety'. Over the last week the 10-year Treasury yield has fallen from 1.84% to 1.75%, although closed well off its low.

Oil rallied substantially towards the end of the week after reports that OPEC (with the encouragement of Iran) might discuss a production cut. Iran still intends to increase production by at least 500 m b/d, and says it is just reclaiming part of the market share that it previously had. In the 'Outlook 2016' we suggested a trading range for the current year of $25-45 on WTI, with most of the bear factors reflected towards the lower end. Time alone will tell, of course, although we did note the existence of a short position recently equivalent to about nine days' consumption. Accordingly we said that 8-12% up-moves (at least of that order) would likely occur. In reality, this kind of price action (and short interest) does suggest a market that is beginning to bottom, especially as the current bear case appears to be substantial although discounted at the low end of the range.

`Gold had its largest one-day rise in seven years last week'

Gold performed very well last week as investors once again favoured the metal as a safe haven, after years of not caring one way or the other. Physical EFT funds saw inflows, and it was reported that China continued to make official purchases in recent months. The price appeared to dig into overhead technical resistance at $1,250-1,256, and may have become exhauseted on the upside for the time being. The FT commented that the yellow metal had its largest one-day rise in seven years last Thursday.

Lastly, our Tactical Asset Allocation Committee met last week, and decided to reduce its overweight positions in both eurozone and Japanese equities to neutral, increasing the underweight position in global equities as a whole. Meanwhile, overall bond positions in our models continue to demonstrate a full commitment to the asset class, very much counter to some views in the market consistent with the yield on 10-year US Treasuries going back towards 3%, or even beyond. Our 'house view' really doesn't see that happening. Now, let's think for a moment - what might cause that to happen? One of the short answers to this could be consistent and large sales of Treasuries by the Chinese (the largest holder of them). Again, we don't see that happening.

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