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From West to East

Weekly Investment View

16th October, 2016

US electioneering in full swing…

The US dollar closed above its July index highs last week, and might be poised to exceed those reached in early March this year. This looks like a clear break-out from its recent range, although some correction to last week's firmness is to be expected. If sustained, dollar strength is unwelcome for the S&P500 in terms of the effect on exports and the translation of foreign earnings back into dollars. The S&P500 closed 1% lower over the week. Last week the quarterly results from ALCOA (always the first to announce in earnings seasons) disappointed, important because of the wide range of uses for aluminium. Better-than-expected results for a few of the leading banks (Citi and JPMorgan) were well-received, helped by trading results from their investment banking operations. The publication of the last FOMC minutes confirmed what we already knew, i.e. that the vote was close, and that the Fed is poised to pull the rate hike trigger. Donald Trump's remaining chances of winning the presidency melted away, with the latest New York Times 'Upshot' analysis suggesting a 89% chance of Hillary Clinton winning. Upsets can happen, yes, but seemingly not this time, especially as Ms Clinton is now leading the polls in Ohio (63%), a historically important indicator state. Elsewhere in the markets we should highlight that sterling resumed its fall (last quoted at $1.2191), as the lead-in to the Brexit negotiations suggested they would be tough, possibly very tough indeed.

'Markets have priced-in a Fed rate hike in December'

In the US, in a speech given by Janet Yellen late last week she suggested it could actually be helpful to allow the US economy to over-heat slightly. This would presumably identify the pressure points and take up spare capacity, with the FT commenting that the US yield curve had steepened as a result, as long-dated bonds moved to price-in higher US inflation in the future. Certainly, if prices cannot rise as one of the main indicators of where assets should be allocated, then capitalism can't work properly. The worries expressed by the more hawkish FOMC members are along the lines that if unemployment were to be allowed to fall towards, say, 4.5% (currently 5.0%), that would definitely be past any notion of full employment, and so inflation could move up from its current 1.7% rate on the PCE deflator measure favoured by the Fed. Under such circumstances the Fed would then have to play 'catch-up', using rate rises to calm the economy down. The quantitative verdict of the markets via the usual Bloomberg measure is that the probability of a rate rise in December stands at 65.9% (and only 17.1% for next month, just four days before the election). Looking at last week's data, US retail sales rose 0.6% in September (vs. expectations for the same amount), and compared to a fall of 0.2% in August. The University of Michigan consumer sentiment index fell to 87.9 in October (from 91.2 in September), and vs. expectations for a rise to 92.0. These data series can be volatile, but overall - and in line with the IMF's changes in its forecasts a week ago - estimates for US GDP growth are being reduced.

In eurozone data releases last week, Germany's ZEW Expectation of Economic Growth index rose to a four-month high of 6.2 in September (from 0.5 in August), and vs. expectations for a score of 4.0. This is rather below the much higher readings of recent years, but at least signifies a bounce from the -6.8 reading in July following the Brexit vote. Within the region, the countdown towards the Italian constitutional referendum on the 4th December has begun.

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'Unfortunately for the UK, it has a high propensity to import'

As mentioned above, sterling came under renewed pressure last week. Prime Minister Teresa May promised a 'full and transparent' debate of the ultimate terms for the intended Brexit, although appeared to stop short of allowing a parliamentary vote on the exit terms. She and her team will oversee the exit, although they understandably will not provide a running commentary on the negotiations. The market response in gilts was an increase in the 10-year yield of 10 basis points, to 1.10%. The UK is facing a divorce bill from the EU for as much as €20bn, according to a Financial Times analysis, following the unravelling of more than €300 billion of shared payment liabilities, going back some years and including pensions, infrastructure projects, and other liabilities. A London School of Economics expert thought their analysis was "completely sound", said the FT. It looks as though the EU will try to force the UK to honour its spending promises, possibly out to 2020, the end of the so-called 'Long Term Budget'. The exit of such a net-contributor truly complicates the EU's finances. The 'periphery' of the EU sees spending programs established before Brexit as legally binding. Germany, France, the Netherlands and Italy, as net contributors naturally don't want the extra financial pressure of filling the budget void, and programs will therefore have to be cut. Otherwise, for the UK, this further fall in sterling should ratchet-up inflationary expectations, something that the gilts market is correctly worried about.

Earlier in the week there was some short-term concern that China's exports had fallen 10% year-on-year in September. Imports had fallen by 1.9%. This concern was partially reversed when it was appreciated that exports expressed in renminbi terms were down about half the amount in the dollar-based number. Imports were up by just over 2% in renminbi terms. Either way the markets were relieved to hear a few days later that Chinese CPI and PPI for September had both been ahead of expectations, and more than hinting at an end to deflationary forces in its economy. The CPI came in at 1.9%, year-on-year, vs. the Bloomberg consensus of 1.6%. The PPI data was the first positive reading (at +0.1%, year-on-year) since March, 2012. The depreciation of the renminbi and the recovery in oil prices will have been instrumental in both readings. The updated official report for the third quarter is due on the 19th October, with economists expecting year-on-year growth of 6.7%, despite still fairly widespread sceptism about China's GDP data.

'Crude oil to remain capped to the upside'

Last week API data out of the US suggested a 2.7 million increase in crude inventories in the most recent week, the first stock build in six weeks. However, distillate stocks fell, regarded as a partial offset in sentiment terms. In nationwide official data, crude inventories were said by the Energy Information Administration to have risen by 4.9 million barrels, vs. expectations for an increase of 900,000 barrels, to a total of 474 million. This is still a high number, although the overall recent trend has been downwards. The US shale producers have continued to become more efficient and reduce costs. Certainly shale oil production would be boosted substantially at $60 thus capping the upside.

The Algerian accord struck recently among OPEC members has allowed some of the non-OPEC producers to be excluded from the agreement. Prior to any accord, OPEC production appears to have risen by about 220,000 b/d last month, to almost 33.4 m b/d (although the IEA estimate is slightly higher), driven by Nigeria, Iraq and Libya. Russia over the weekend intimated that a freeze was more likely than a cut. One of the most important determining factors for oil prices will be the pullback in substantial capital expenditure by the oil majors who in many cases have not been able to maintain budgets. The cancellation of future projects will lead to reduced supply to the markets, and be supportive for prices. Recent Chinese data on crude oil imports climbed to a record level on further strategic reserve buying. China retains its crown as the world's biggest oil consumer, ahead of the US.

'Gentle crude oil price rises should keep inflation in check'

Goldman Sachs has estimated that the oil price recovery seen so far could lead to a reversal in annual CPI inflation in the advanced economies, from an a 0.5% reduction, to an increase of about 1% by early next year, and they describe this is a 'Goldilocks' situation. The world should be able to accommodate this; consumer spending would not be badly affected, and oil prices could be high enough to reduce financial pressures on some of the marginal producers, and parts of the emerging world dependent upon oil revenues.

Question marks do still remain about the outcome of the US election, as well as the potential outcome of Brexit. Looking ahead, markets will begin to start focusing on Europe again, post the US elections. It's not yet a totally done deal for Hillary Clinton, as the Populist vote should not be underestimated these days. Market volatility is expected to pick up in what is a largely tempered environment for risk-taking. Volumes are expected to drop off as we approach the 8th November. US Treasury yields, however, do not as yet suggest any significant dangers for markets.

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