Possible market rotation underway

Although the week in equities finished on a rather sombre, France-influenced note, the underlying sentiment change for the positive remains intact, following the attainment of four new all-time highs for the important S&P500 index. The coup attempt in Turkey will now have to be digested by the markets, reminding us that the path to increased wealth is rarely uninterrupted. Less importantly, but a surprise nonetheless, the Bank of England held rates when most had assumed a reduction of 25 basis points.

'US equities are climbing a wall of worry'

The S&P500 closed up 1.5% last week, in a way that brings to mind the adage 'climbing a wall of worry'. In Europe, the Euro Stoxx 50 index was up by 4.3% on the week; stocks have continued to brush aside Brexit insofar as its effects will only be felt over time - but in the meantime life in the markets continues. The Nikkei 225 index had a really excellent week, closing up 9.2% on the back of expected fiscal stimulus and marked yen weakness (finally!). The US 7-10 year bond index fell 1.4% over the week, with the US 10-year yield currently standing at 1.5509%, markedly up from the 1.3579% close at the end of the previous week immediately after the Brexit vote. Gold corrected by about $50 off its Brexit high of 1,375, although has steadied at $1,337 as we go to print.

The amount of outstanding government debt trading with a negative yield is shooting about at the moment, and we continue to study this curious phenomenon. How can any government paper be held in such high esteem? Bank of America Merrill Lynch recently produced an estimate of $13 trillion, which included a large percentage of European and Japanese government bonds. In fact, Germany set a new record in financial markets last Wednesday, when it became the first eurozone country to sell 10-year bonds with a negative yield in a government auction; the sale of 10-year Bunds with a yield of minus 0.05% made it the third country (after Switzerland and Japan) able to, in effect, charge investors for lending their money. Quality sovereign yields moved higher during the week, partly mirroring the 'risk-on' mood elsewhere, and it is tempting to think we may have seen a short-term bond peak. Technically, the yield on the US 10-year would have to break solidly above about 1.83% (and remain there) to suggest a 'big' trend reversal. Investors' expectations of continued monetary accommodation by the world's central banks may have become over-extended. Very low bond yields have latterly been a function of Brexit concerns (and the expected necessary central bank easing to calm the situation), although Brexit fears are rapidly receding - and expectations for US growth appear to be increasing, and are probably stabilizing elsewhere after moderate GDP estimate reductions, e.g. for the Eurozone.

'Trump chooses his running-mate'

The fact that US equities have reached new highs is especially impressive given the approach of the US Presidential Elections, and this week's party conventions. What the markets seem to be saying is that the Street has decided Hillary Clinton will be the new president. She is not very popular, but at the end of the day that may not actually matter much, because the supportive machinery behind US government is in place. At least she is a known quantity. Otherwise, Mr Trump's selection of Indiana Governor, Mike Pence, seems to have been on the basis that this gentleman's solid and religious background bring some desirable aspects to the Trump campaign.

Claude-Henri Chavanon

Managing Director
Head of Global Asset Management

While on the subject of politics, in the UK the new Prime Minister, Teresa May, put together her Cabinet. Phillip Hammond is the new Chancellor of the Exchequer, which has been quite well-received (as he has real-world industrial experience), while less well greeted in certain international circles was the appointment of Boris Johnson as Foreign Secretary, stemming principally from his not always diplomatic behaviour in recent years. The mixture of ministers includes some serious Brexiteers, who will be expected to help turn Brexit into reality in a practical way. As Ms. May put it, in stoic fashion, "…and we are going to make a success of it". Although the immediate months to come will be very tough, she probably stands a good chance of doing so. Looking at sterling last week, upon the appointment of the Cabinet, it rallied, and then weakened slightly towards $1.32 as some of the realities set in – and once the rate rise from the Bank of England didn't happen. The latter, as it happens, now looks quite clever, in that it has avoided a look of panic, and maintains flexibility for the future.

'The US is doing quite well, economically'

The Citi US Economic Surprises index has rallied from -19.80 at the end of June, to +21.90 at the end of last week, having been below zero since January last year. In US economic data last week, in the vanguard was a very good retail sales print, which saw a 0.6% increase in June, vs. a consensus estimate of just 0.1%, and which beat the highest forecast gathered in a Bloomberg survey.

In other US economic data, US producer prices (PPI) posted their largest gain in 12 months during June, increasing by 0.5% month-on-month, vs. expectations of 0.3%, and up from 0.4% in May. June's result was led by a 4.1% increase in energy prices, after a 2.8% gain in May, while services' prices rose by 0.4%. The year-on-year gain was 0.3%. Excluding the volatile food and energy components, the 'core' PPI on a year-on-year basis rose by 1.3%, vs. 1.2% previously; the Fed prefers the 'core' PCE deflator as its chosen measure of inflation. Overall, this recent US data should cement a reasonably good second-quarter GDP out-turn, perhaps in a range of 2.5-3.0% on an annualized basis. It is worth noting that Alcoa is always the first to announce figures each quarterly results season, and early last week they beat expectations both at the top and bottom line, with the significance being that aluminium has a broad spread of modern-day applications (packaging, through to transportation) and is correctly perceived as an industrial bell-weather metal, reflecting conditions across a range of sectors.

'China is truly complex to analyze'

China's second-quarter GDP grew 6.7% year-on-year, marginally beating the consensus estimate of 6.6%, and consistent with the official target range of 6.5-7.0% growth for 2016. Retail sales rose by 10.6%, beating the 9.9% expected; industrial production rose 6.2%, vs. 5.9% expected. Fixed-asset investment decelerated, however, to 2.8%, thought to reflect weakness in this within the private sector. Given the rapidly rising leverage in the public sector, the sustainability of prevailing infrastructure financing continues to come into question. As the FT has pointed out, the revival in real estate, especially in large cities, has been crucial to enabling China's economy to avoid a hard landing. As part of a continuing effort to boost infrastructure spending and sustain growth, the State Council approved the 'Medium to Long-term Railway Network Plan' at its executive meeting on the 29th June, calling for eight new north-to-south and east-to-west railways lines to significantly reduce travel time between major cities and city clusters. China has begun to plan the development of new high-end equipment manufacturing industries in the provinces of Zhejiang and Jiangsu, according to the Economic Information Daily, including aviation, shipbuilding and alternative energy. These are just a few examples of initiatives underway. While we can be skeptical regarding Chinese growth statistics, we continue to look for signs of a turn in their securities markets. We will continue to knock 2% off the stated growth numbers. Meanwhile, last week the yuan traded near its weakest levels in almost six years.

'Have we seen definitive market signals?'

Our TAA Committee is scheduled to meet tomorrow (Monday, 18th July). We have maintained a neutral weighting in global equities, tilted a few weeks ago to an overweight in US stocks, vs. being underweight in European stocks. In the last Weekly Investment View we wrote, "we have been mindful that short positions are under pressure, and that billions of dollars of corporate cash could be applied in M&A activity". The report finished by saying that "investment strategy remained essentially unchanged, pending more definitive signals from the markets". The Committee will discuss the extent to which a 'definitive signal' has been received, considering the constructive technical behaviour of the S&P500 last week. In the meantime, there has been the matter of an attempted coup in Turkey to be considered, and such a factor could be sufficient to instigate at least a pause in the new bullish tone in equities.

As we wrote in a memo last week, "Markets move with the 'weight of money' applied to them, even if that money is to an extent debased. The best markets are ones that appear to be climbing 'walls of worry'. Perhaps above all, investors ignore new highs at their peril, as they only turn out to be bull traps occasionally. Earlier this year we used the phrase 'Fear Of Missing Out' (FOMO); that is what we are likely to see. If the markets - led by the S&P - do continue to climb, let's hope this doesn't presage a bubble. In the meantime, however, those overweight in cash will be getting more worried".

For any inquiries related to this article, please contact Alain.Marckus@nbad.com

Disclaimer:

This report has been prepared and issued by the Global Asset Management ("GAM") of the National Bank of Abu Dhabi PJSC ("NBAD") outlining particular services provided by GAM and does not constitute or form part of any offer or invitation to sell, or any solicitation of any offer to purchase or subscribe for, any shares in NBAD or otherwise or a recommendation for a particular person to enter into any transaction or to adopt any strategy nor shall it or any part of it form the basis of or be relied on in connection with any contract therefore. This report was prepared exclusively for the benefit and internal use of NBAD. This report is incomplete without reference to, and should be viewed solely in conjunction with the associated oral briefing provided by GAM. The report is proprietary to GAM and may not be disclosed to any third party or used for any other purpose without the prior written consent of GAM. The information in this report reflects prevailing conditions and our views as of this date, which are accordingly subject to change. In preparing this report, we have relied upon and assumed, without independent verification, the accuracy and completeness of all the information available from public sources or which was otherwise reviewed by us. In addition, our analysis are not and do not purport to be appraisals of the assets, stock or business of the recipient. Even when this presentation contains a kind of appraisal, it should be considered preliminary, suitable only for the purpose described herein and not be disclosed or otherwise used without the prior written consent of GAM. NBAD clients may already hold positions in the assets subject to this report and may accordingly benefit from the buying or selling of such assets as referred to in this report. This document does not purport to set out any advice, recommendation or representation on the suitability of any investment, transaction or product (as referred to in this document or otherwise), for potential purchasers. Potential purchasers should determine for themselves the relevance of the information contained in this document and the decision to purchase any investment contained herein should be based on such investigation and analysis as they themselves deem necessary. Before entering into any transaction potential purchasers should ensure that they fully understand the potential risks and rewards of that transaction (including, without limitation, all financial, legal, regulatory, tax and accounting consequences of entering into the transaction and an understanding as to how the transaction will perform under changing conditions) and that they independently determine that the transaction is appropriate for them given their objectives, experience, financial and operational resources and other relevant circumstances. Potential purchasers should consider consulting with such advisers and experts as they deem necessary to assist them in making these determinations and should not rely on NBAD for such purposes. NBAD is acting solely in the capacity of a potential arm's-length contractual counterparty and not as a financial adviser or fiduciary in any transaction unless we have otherwise expressly agreed so to act in writing. NBAD does not provide any accounting, tax, regulatory or legal advice. NBAD is licensed by the Central Bank of the UAE.

London

NBAD London Branch is Authorised by the Prudential Regulation Authority. Subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details about the extent of our regulation by the Prudential Regulation Authority are available from NBAD London branch on request. Registered in England & Wales: Company No: FC009142: VAT No: GB245 3301 91.

Paris

NBAD Paris Branch is licensed by the French Prudential Control Authority as a credit institution. NBAD Paris is registered in France under the company number: RCS Paris B 314 939 547.

Switzerland

This publication is for your information only and is not intended as an offer, or a solicitation of an offer, to buy or sell any investment or other specific product. Certain services and products are subject to legal restrictions and cannot be offered worldwide on an unrestricted basis and/or may not be eligible for sale to all investors. All information and opinions expressed in this document were obtained from sources believed to be reliable and in good faith, but no representation or warranty, express or implied, is made as to its accuracy or completeness. All information and opinions as well as any prices indicated are currently as of the date of this report, and are subject to change without notice. The analysis contained herein is based on numerous assumptions. Different assumptions could result in materially different results. At any time the National Bank of Abu Dhabi PJSC and/or NBAD Private Bank (Suisse) SA may have a long or short position, or deal as principal or agent, in relevant securities or provide advisory or other services to the issuer of relevant securities or to a company connected with an issuer. Some investments may not be readily realizable since the market in the securities is illiquid and therefore valuing the investment and identifying the risk to which you are exposed may be difficult to quantify. Futures and options trading is considered risky. Past performance of an investment is no guarantee for its future performance. Some investments may be subject to sudden and large falls in value and on realization you may receive back less than you invested or may be required to pay more. Changes in foreign exchange rates may have an adverse effect on the price, value or income of an investment. National Bank of Abu Dhabi PJSC expressly prohibits the distribution and transfer of this document to third parties for any reason. National Bank of Abu Dhabi PJSC and/or NBAD Private Bank (Suisse) SA will not be liable for any claims or lawsuits from any third parties arising from the use or distribution of this document. This report is for distribution only under such circumstances as may be permitted by applicable law. The "Directives on the Independence of Financial Research", issued by the Board of Directors of the Swiss Bankers Association (SBA) do not apply.