From West to East
Weekly Investment View
18th April, 2016

# A confluence of crossroads

**Last week the S&P500 was 1.6% firmer, and now stands 1.8% ahead for the year.** The earnings season has been quite poor so far, yet some commentators have been suggesting this is already priced-in. This leading bell-weather index in the meantime remains rather on a 'knife edge' in terms of whether the next move will be a break to the upside in defiance of gathering recessionary evidence, or a lurch downwards as further mutual fund net sales occur. We have repeatedly argued the (especially valuation case) 'against' in recent months, yet are now more prepared to be wrong in our bearish view, given the willingness of central banks around the world to extend their monetary stimulation.

## *'Expansions do die of old age'*

**There was some quite telling data out of the US last week.** While weekly jobless claims registered a 43-year low, the University of Michigan consumer sentiment index fell to 89.7 for March (vs. expectations of 92.0), echoed in a 0.3% fall in retail sales for the same month. The latter was mainly attributed to weak motor sales; when American consumers feel good, they buy new cars. The CPI for March came in at +0.1%, below expectations of +0.2%. At the same time, on the other side of the US economy, industrial production for March fell by 0.6%, vs. expectations of -0.1%, being the sixth decline in seven months. Given such a trail of data points, it is perhaps unsurprising that many economists have penciled-in recent/ current real GDP growth approaching zero.

**Following-on from the recent US data mentioned above, our readers will be interested to hear that the US Labor Department reading of 'core' inflation (i.e. excluding food and energy) is +2.2% over the last twelve months.** While this is not the Fed's preferred measure (they use similar data from the Commerce Department), the direction of travel is perhaps instructive. The preferred data series has been running below Labor Department data, certainly, but it could well be that the Fed is now really between a rock and a hard place: what if the underlying inflation metrics - even having excluded recently rallying oil prices - are now at or close to the Fed's target of 2%, yet they cannot raise rates for fear of pushing growth below zero? We could be being overly pessimistic, yet readers will take the point. Academically speaking, and given the growing probability that there might not be any increase in US rates at all this year, the justified P/E ratio on the average stock could be kept rather higher than otherwise, and perhaps despite US politics, as the net present value of cash flows and dividends is maximized for longer. Politically, Wall Street is assuming a Hillary Clinton win in November.

## *'China: problems discounted, so go with it?'*

**Chinese stocks rose 3.1% on the back of the publication of a 6.7% year-on-year growth rate in real GDP for the first quarter, in line with the median expectation of economists surveyed by Reuters, and in the middle of the 6.5-7.0% official target for the current year.** Yes, we understand the doubts surrounding the statistics, although like everyone else have to assess what is provided. Loose monetary policy on one hand and expansionary fiscal policy on the other appear to have helped stabilize the areas of the economy (real estate, construction, heavy industry) that needed it, and in fact caused a good bounce in the housing sector. Critics would say that growth of money supply (M2) of 13.4% year-on-year in March is irresponsible, but it could have been necessary. Meanwhile, the services sector - although recently

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slowing - appears to have been growing at an annualized rate of between 7.5 and 8.0%, going some way to offsetting manufacturing growth that has slowed to less than 6%. While the transition from an industrial to a more consumption-led economy will not happen overnight, we are excited that retail sales growth in China has been impressive. The savings rate, estimated to have been as high as 30% in recent years, might actually be falling.

**As an interim conclusion on China, we are beginning to come off the fence, having recently said we have that 'investible' universe under review.** We have more work to do, certainly, but it is now with positive implications. The Chinese authorities have been doing the right kinds of things to encourage foreign investment in the future, to the point where fund outflows have stabilized compared to earlier in the year. They obviously want to facilitate a positive MSCI 'Emerging Markets' move, and there is a growing feeling that this may now happen sooner rather than later (although when it does happen it will be phased). It is well-known that previously 'locked up' stock sales must be allowed over time, and this would reduce the technical overhead resistance. Some of the increases seen in selected commodity prices are testament to the possibility that the tide in Chinese investment sentiment has genuinely bottomed.

## *'Germany and the IMF have warned about Brexit'*

**Germany's finance minister, Wolfgang Schäuble, has served notice to his British counterpart, George Osborne, that Germany would give the UK a very hard time in trade and any other negotiations following the reality of a Brexit.** The divorce would not be easy, and any assumptions suggesting otherwise by the 'Leave' camp look short-sighted. The polls are showing a picture of the race being 'neck-and-neck', although the (usually more reliable) odds quoted by bookmakers still suggest something like a 65/35 Against/For Leaving split, so there is hope for the 'Bremain's', like ourselves. The remaining source of most uncertainty in a voting sense is that some have the 'undecideds' as high as 20%, which is equivalent to a substantial margin of error. Accordingly, sterling will continue to feel the pressure. In the meantime, we understand there are even some signs that the London property market is becoming a bit nervous. Last week the IMF warned of the regional (and even global) damage that could follow a Brexit. We will be in the UK just before the vote and will send messages back from the front.

**As we go to print the Doha oil production restriction discussions are taking place.** Our readers will have heard much about this already, so we won't discuss this at length. In summary our thoughts are as follows: (1) To be honest, our expectations are very low for any kind of satisfactory outcome, given that Iran considers that its 'returning' status excludes it from the equation; (2) The IEA put it best when they said in their latest review that the impact of any freeze in production agreed would be limited; (3) If there was agreement to freeze output, it couldn't be policed; (4) In all probability the global supply-demand balance has already begun to improve at the margin, from the demand side (e.g. from India); (5) While US shale production is definitely being reduced, even if it falls by an average of one million barrels/day for the year as a whole, that would still be only about 1% of global production, easily filled by various other producers; (6) The prices of Brent and WTI have risen from recent lows, partly based on some expectations of a bullish outcome out of these talks. In conclusion, while the lower limit of the WTI range has probably increased slightly (to perhaps $28 or so), the projected upper level of $45 still looks very much intact.

## *'Is a Rousseff exit already priced-in?'*

**Brazilian markets have been rallying the past few weeks as the possible impeachment of Dilma Rousseff is being seen as a fresh start for the country, with talk of a possible Lula-led or Lula allied government taking control.** Lula De Silva, the former President, was credited with bringing Brazil into the top tier of emerging market nations known at the time as 'BRICS'. The macro picture in Brazil has been extremely negative, made worse with the bribery allegations at Petrobras known as the 'Car wash' scandal. We will be commenting further, once the Chamber of Deputies has voted on whether to move the impeachment process forward to the Senate.

**The GAM Tactical Asset Allocation Committee this week made the following decisions:** (1) To close the US Equities underweight, on the basis that the dollar looked oversold and the possibility that technical influences could still take the market to a new high based on sustained real-zero interest rates and global QE; positioning can be re-visited once the market direction becomes clearer; (2) To close the High Yield Corporate Bonds overweight, after short-term strength partly on the back of higher energy prices, and because of concern that the HY corporate credit cycle could deteriorate; (3) To close the MENA Equities underweight, partly on the basis that whatever the outcome of the Doha talks, energy prices are tracing out a gradual recovery, also that PE/Growth considerations in the years to come argue in favour of this asset class being cheap, and (4) To close the Hedge Funds overweight, partly to help fund the decisions above, and pending a review of that asset class.

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