From West to East

Weekly Investment View

18th September, 2016

It's not all just about the US

The S&P500 is down by just under 1.9% over the last few weeks, after a small recovery last week. It had been trading in a tight range between about 2,160 and its record close of 2,190, and has broken to the downside. September could now be living up to its reputation (borne out statistically) for often being a tricky month for markets. Volatility has certainly jumped, initially in stocks, and also in bonds. Significantly, banking stocks have been hit by the $14 billion penalty handed out to Deutsche Bank by US regulatory authorities. Elsewhere, oil prices have traded down to $43.03 on WTI in the wake of some bearish prognostications from various industry bodies, pushing energy stocks lower. In addition to worries about a Trump bounce-back (partly on the back of Hillary Clinton's tribulations), there are next week's US Federal Reserve and Bank of Japan policy outcomes to consider. Investors have been confused by the apparent inconsistency inherent in FOMC officials' recent speeches. US economic data has been more down-beat in recent weeks, implying less leeway for the Fed hawks wanting to hike rates next week. The market nervousness appears to have its roots initially in the ECB not loosening monetary policy further two weeks ago, swiftly followed by Eric Rosengren's (Boston Federal Reserve President) hawkish comments. A proportion of recently negatively-yielding issues have moved back into or towards positive yield territory. For instance the German 10 Year Bund yield has moved back to fractionally above zero, from -0.12% a week ago, and Japanese 10 Year bonds now yield -0.04%, up from an all-time low of -0.28% in late July.

'The skills shortage in the US will restrain growth'

The US economy expanded at a moderate pace in July and August, the Federal Reserve said in its Beige Book, with few signs of meaningful wage pressures beyond highly-skilled jobs. Many of the Fed's 12 districts reported increased wage pressures for highly-skilled workers, and difficulty filling job vacancies, "especially those aimed at technology specialists, engineers, and selected construction workers". So despite the US labour market nearing full employment, that has as yet not sparked broadly-based higher wages, or, in turn, the higher inflation targeted by the Fed. US job openings improved to a record high in July (since records began in December, 2000), suggesting employers are having a hard time finding the right candidates to fill some positions.

Retail sales in the US during August fell by 0.3% month-on-month, vs. expectations of -0.1%, and from an upwardly-revised 0.1% gain in July. The slackness was broad-based. Sales at non-store retailers (including online) fell 0.3%, while department store sales fell 0.6%. So-called 'core' retail sales, excluding autos, gasoline, building materials and food services, fell by 0.1% (vs. expectations of +0.4%), after a downwardly-revised -0.1% for July. Headline retail sales were up 1.9%, year-on-year. At the other end of the economy, US industrial production fell 0.4% in August. The sector accounts for about 12% of the US economy, and has been suffering from destocking.

'The probability is now against a US rate hike next week'

Current expectations via the futures markets suggest a 20% probability of a 25 basis point increase in the Fed funds rate after the FOMC completes its deliberations next Wednesday, down from 32% a few weeks ago. Being rather behind the curve, the Fed is under pressure to continue to 'normalize' rates before the economic cycle turns down. At the other end of the monetary policy spectrum, the Bank of Japan is under pressure to ease policy further as the central bank conducts its 'Comprehensive

Claude-Henri Chavanon

Managing Director
Head of Global Asset Management

Assessment' of the effects of its stimulus program at its own 20th-21st September policy review. There remains disappointment that the ECB didn't extend the end-date of its quantitative easing programme, adding to thoughts that its bond-buying program has reached its practical limits. Back in the US, the Richmond Fed's Lacker has said the case for a rate increase this month is strong, the Kansas Fed's George has said the labour market is "…at or near full employment", countered by the Federal Reserve Board's Lael Brainard, who has recommended caution in rate increases. Back in the hawk camp, Eric Rosengren of the Boston Fed is concerned that the US economy might overheat if rates are kept too low and for too long. A recent straw poll of the 12 voting FOMC suggested that eight are in favour of hiking, although that probably pre-dates the latest flat US economic statistics. While the outcome from the Fed next week will be a major market signpost, the 26th September Presidential debate is sure to be another.

In Eurozone economic statistics, Germany's July industrial production fell by the most in almost two years,

not helped by slack world trade. It fell by 1.5% from the previous month, vs. expectations of a 0.1% gain in a Bloomberg survey. Consistent with this, German's trade surplus fell in July to Euro 19.5 billion, vs. Euro 23.7 billion, down from Euro 24.8 billion in July last year. Exports fell by 2.6% month-on-month, vs. +0.4% expected, and imports fell 0.7% (vs. +0.5% expected). French industrial production was also weak in July.

'Oil prices heading back to our buying area near $40?'

As mentioned earlier, oil prices were weak last week. US inventory statistics have been difficult to interpret lately, due to tropical storms and hurricane Hermine forcing the industry to draw down inventories, which will probably now rise as oil imports come ashore more regularly. Significantly, the International Energy Agency said it now expected the global oil glut to last well into 2017, with supply expected to continue to exceed demand through the first half of next year, and that production by OPEC's Gulf producers are a contributory factor. Elsewhere, the US Energy Information Administration said it expected 2016 US crude production to fall by slightly less than expected, to 8.77 million barrels/day, and 2017 output will also fall by less than previously expected. OPEC said its production remained at near-record highs in August, and they revised up their estimate of non-OPEC output for both this year and next, but kept its demand forecasts largely unchanged. They still expect non-OPEC supply to fall this year, however.

Turning to Chinese economic data, exports rose for the sixth consecutive month in August, cushioned by the weaker yuan, (although they fell in dollar terms). More interesting is that Chinese imports rose in dollar terms for the first time since 2014 (by 1.5%, year-on-year). China's foreign exchange reserves fell by about $16 billion in August, as the country's central bank sold dollars to defend its currency against capital outflows, to just under $3.19 trillion (but still huge). The economy expanded at 6.7% in the April-June period, the same as the first three months of the year and down from 6.9% in 2015. Although the numbers may be optimistic, we are told that industrial production grew 6.3% year-on-year in August, up from 6% in July and slightly above expectations. Retail sales grew 10.6% year-on-year, up from July's 10.2% and above expectations for no change. Growth in fixed asset investment was steady at 8.1%, 0.2% above expectations.

'The Chinese are going to be full members of the economic system'

Staying with China, during the last few weeks there has been talk that the People's Bank of China has been intervening in the offshore yuan and banking markets to discourage traders prepared to short the currency. We would like to remind our readers that on the 1st October the yuan will enter the International Monetary Fund's reserve currency basket, joining the dollar, yen, sterling and euro, facilitating its increased use. According to Bloomberg, only just under 2% of global payments are currently being settled in yuan. The US will have to cope with the internationalization of the Chinese currency, and global central banks will be obliged to include it in their forex reserves. The world monetary system may ultimately become stronger through this increased diversity, although it will take years to fully evolve. Bloomberg reminds us that Chinese stimulus after the Great Recession helped the economic system survive. The yuan will join the IMF's Special Drawing Rights (SDR) basket with the third-largest allocation. The dollar's supremacy will not disappear anytime soon, but the Chinese will continue to make their presence felt.

INVESTMENT SUMMARY:

At its most recent meeting (the week before last) our Asset Allocation Committee voted to reduce its US equities weighting to neutral, pending the Fed rate decision, but also due to relative valuation in a market where on average earnings estimates have recently been static. The S&P500 is trading on a P/E of 16.1x for 2017, based on earnings growth of 13.2%. The yield is 2.16% (for 2017), Price/Book is 2.70x, and Price/Sales is 1.85x. At the same time, the Committee decided to move overweight in Eurozone equities, as they look much better value on a relative basis: the Euro Stoxx 50 index is trading on a P/E of 12.3x for 2017, based on earnings growth of 12.3%, the yield is a useful 4.13%, Price/Book is 1.32x, and Price/Sales is 0.97, so they already look quite bombed-out. Also, based on the above, the PE-to-Growth ratio for 2017 is 1.00 in the Eurozone, compared to 1.22 for the S&P500. The Committee still has cash balances to put to work, preferably at lower levels into equity weakness that 'seasonality' - and in all likelihood politics - might serve up.

'Don't overstate headwinds to Emerging Markets'

Looking to the medium-term, and at Emerging Market assets, we agree that that these can be hit via higher borrowing costs, and that a few still have current account deficits to be dealt with. However, as Capital Economics says, the average EM deficit as a share of GDP today is lower compared with the 'Taper Tantrum' period of May, 2013, with improvements particularly sharp in India and Brazil. The prospects for the major EMs - the BRICs - will be shaped by developments in domestic policy, rather than by US Federal Reserve-initiated changes in interest rates. **The still-high economic growth in China, and related improving state of China's imports will be very important for other emerging markets, as well as providing good opportunities for global investors.**

Alain.Marckus@nbad.com
Clint.Dove@nbad.com

NBAD