NBAD

From West to East

Weekly Investment View

20th of November, 2016

Investors view developed market equities more favourably

The S&P500 has continued to rally, and was up 0.9% over the week as funds flowed into US equities in size in a further reaction to the results of the US elections. Uppermost in the minds of investors has been the expectation that the incoming Trump Administration will reflate the US economy, mainly via a significant ramping-up of infrastructure spending, also facilitated by an overall reduction in business regulation. The S&P settled just 0.4% shy of its August all-time high, constrained by sustained strength in the dollar, which serves to de-gear the foreign earnings of international multinationals. Small and mid-cap companies have lower international earnings, so the Russell 2000 index was not constrained in this way, closing at a new all-time high of 1,315.64. European equities followed suit, up 0.6% over the week, although the stand-out performance for the week came from Japanese equities, which closed up 3.4%, helped by yen weakness. In terms of its index, the dollar was 2.1% higher over the week (to 101.21), with investors torn between a feeling that ten 'up' days may well have left the currency looking over-bought, offset by the likelihood that such impressive upside momentum cannot be ignored. The imminent vote on the Italian constitutional referendum will likely contribute to further downside risk for the Euro, further adding to US dollar strength. At the end of 1984 the US dollar index exceeded 150, and almost reached 120 in 2001. By the end of last week the Bloomberg probability reckoning (largely confirmed by comments from Fed Chair Janet Yellen) for a December rate increase had risen to 98.0%, with up to three further hikes now expected next year. Although off its intra-day highs, the yield on the 10-year US Treasury bond closed at 2.35% (+ 20 basis points over the week), as investors sold Treasuries. Investors expect fiscal stimulus to have to be counteracted by tighter monetary policy, in the face of higher US GDP growth and inflation. Investors are now having to consider how they view equities vs. bonds i.e. the trade-off between higher expected earnings growth in equities, and the extent to which higher interest rates might impact this positive development in practice. In the meantime, the markets are already beginning to get used to the new scenario. **Our Asset Allocation Committee meets at the end of this week and will be fine-tuning investment policy. Until then we remain neutrally-weighted in US equities, and overweight in Eurozone equities with the currency fully hedged.**

"It's early days, but the Trump factors appear net-positive"

There has been much discussion of the so-called 'Trump-flation' sectors since the US election results became known, and it looks as though investors on average are prepared to travel hopefully as events unfold and as more becomes known about this Brave New World. Some quite strong market moves have occurred .e.g. for the month-to-date US Financials are up 12.3%, Industrials by 7.1%, Consumer Discretionary by 3.9%. and Materials by 3.3%, compared to an increase of 2.8% for the S&P500. This bullish/'risk-on' rotation is underlined by Utilities having fallen by 6.4%, and Consumer Staples by 4.4% as investors quickly restructured many portfolios to reflect some of the new potential realities. The MSCI Emerging Markets index is down 6.6% for the month-to-date, in a 'Trump taper tantrum' response as the dollar strengthens and expectations for higher rates percolate through the system. At some point this blanket logic will be taken too far, and investors will be reminded that many emerging markets are in far better economic shape than they were at the time of 2013's legendary Taper Tantrum – although we seemingly haven't arrived at that point yet. **Otherwise, analysts have been looking at events such as the significant upward move in copper prices to $2.50/lb, and doing the 'demand intensity' numbers, concluding that this initial surge in prices owes a bit too much to speculative forces and has likely been overdone.**

Claude-Henri Chavanon

Managing Director

Head of Global Asset Management

All eyes have been on the details of the President-elect's cabinet as they have become known. The appointment of Reince Priebus as Chief of Staff has been well-received, as he is the head of the Republican National Committee and so provides the all-important link to Congress (also he is known to be very close to Paul Ryan, the House Speaker). This looks to be a clever choice, as the incoming President needs Congress, and commentators have for instance been happy to see Trump request a meeting with Mitt Romney, one of his fiercest Republican critics and still very influential within the Party. The appointment of Stephen Bannon as Chief Strategist was not so well received, however, and the details that have emerged over the weekend - Jeff Sessions as Attorney General, Mike Flynn as National Security Advisor, and Mike Pompeo as Director of the CIA - make it clear that the President-elect will have a core of hard-liners close to him as he proceeds to shake Washington up. And shake it up he will. This is what the people voted for, and this is what investors are coming to terms with. Of course it is very early days. In the meantime, it is good to see distractions such as Trump University litigation being dealt with. It all comes back to the phrase 'travelling hopefully', as this is what markets really want to do, and we sense that quite strongly. **As discussed above, the weight of money has driven an intense series of rotations in the days since the US election result, and although one must not jump to too many conclusions as this stage we are erring on the side of optimism - certainly for equities as a class, and especially in developed markets.**

> *"The Indian economy is probably strong enough to withstand the recent measures"*

A few weeks after the Modi government's initiation of 'demonetization' (cancellation of 500 and 1,000 rupee banknotes, replaced by 2,000) in India, we are still aghast at the sheer boldness of this move, which was done for all the right reasons. Official data from 2013 has suggested that only about 1% of the population pay any tax at all. The size of the black economy is thought to be about 20% of current GDP, although some estimates are higher than this, at up to 38%. If future tax revenues can be boosted, there could be a massive overall benefit to the population and the economy, even if by necessity the pain is falling disproportionately on the poorest in the short-term. Amnesties had already been offered to those willing to declare their black money assets, and most people are solidly in favour of the move. Our sources estimate that roughly 10% of the economy could be subject to capital destruction, through punitive fines and back-taxes, or old currency being destroyed or remaining un-exchanged. Also, it is clear that many existing trade and wholesale supply chains have been severely disrupted or totally halted. Being a consumption-led economy, an immediate adverse impact on consumer spending will be painful, and can be expected to back-up through the system. Non-performing loans can be expected to increase, and many small businesses could fall by the wayside. In bottom-line terms, we are told to expect a few quarters of sub-3% growth, before the economy bounces from a lower (but higher-quality and fiscally more efficient) level. Since the new monetary regime was introduced, Indian equities have fallen by about 4.3%, and the rupee is 2.5% lower against the dollar, although at a time when the latter has been strong. Real estate values could also correct, as black money was quite important in that sector. Mr Modi could see that (a) Indian GDP growth was strong enough and inflation now sufficiently low for the economy to weather such changes, and (b) he is half-way through his tenure, so time was running out to act. We believe the short-term pain will be worth the long-term gain, provided the new 2,000 rupee bank note can be prevented from becoming the new basis for the black economy. **We remain neutral in emerging market equities as a class.**

Turning to Mena equities, we note that Saudi Arabia's Tadawul index has rallied by 21% off its low of early October, and was up by 1.5% last week, ahead of Abu Dhabi and Dubai, which rose by 0.2% and 1.1% respectively. In Saudi Arabia, equities there have continued to benefit from the recent highly successful bond issuance, and optimism related to their National Transformation Plan. Added to this, local newswires have reported that the country has paid 40 billion Riyals of the amount outstanding to contractors, with the National Contractor's Committee stating that the government is expected to pay 80% of the total amount due to contractors this year. The Saudi interbank rate has begun to soften, and should continue to do so once further payments are actually received. Some commentators believe that MENA equities as a class represent quite compelling value, perhaps with the exception of Egypt, despite the initial tranche of its IMF loan ($2.75 billion) being paid, linked to the float of the Egyptian pound. Overall, as in more normal periods, MENA equities can now be expected to be driven by crude oil prices, although not forgetting that the supportive dividend season is approaching. WTI rose by 5.2% last week, despite the Baker Hughes US rig count ticking up by 19, to 471 active rigs, reflecting rhetoric suggesting that there remains a chance that OPEC will agree a production accord at its 30th November meeting. **Our main message is to maintain a neutral position in MENA equities at this time.**

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

From West to East

Weekly Investment View

20th of November, 2016