From West to East

Weekly Investment View

22nd February, 2016

The Fed is still 'between a rock and a hard place' - but is not alone!

The minutes from the January FOMC meeting were published last week. Most members appeared to agree that the outlook for the US economy had deteriorated in the light of the substantial market volatility seen in the early few weeks of the year, also referencing increased global downside risks. In reality the position the Fed finds itself in has become worse - a genuine 'lose-lose' situation: if they were to raise rates further in the months ahead it could be just as core inflation (the Labor Department measure of this rose to 2.2% year-on-year in January) begins to take hold, leaving them even further behind the curve. If they reverse course on rates now, they will lose whatever credibility they still have. By now the Fed will have realized that even December's small 25 bps increase in the Fed Funds rate has likely had outsize ramifications for the US economy. The dollar may have weakened, although on a technical trade-weighted basis it does not look to have peaked, so even a further 25 bps could cause renewed and economy-damaging dollar strength, especially given negative rates elsewhere. As we have recently stated, we do not expect a US rate increase anytime soon. US industrial production for January came in better than forecast (at +0.9%), attributed to a weather-related recovery in utilities' output, offset by housing starts being unexpectedly weak that month. Economists are continuing to edge their GDP growth estimates for the current year downwards.

`The Presidential election will begin to increase market volatility'

From this point, the US equity market is likely to gradually pay more attention to the Presidential election due this November. Just as we were looking for some new quality input on this point, John Authers of the FT delivered in the 'FT Weekend'. In essence, Mr Authers notes that 'prediction markets' continue to suggest a 62% Democrat victory, and that this would not be such a bad eventual outcome for the markets. While an eventual upset is always possible, we think Hillary Clinton (while certainly not universally popular or trusted), may be the best practical choice in the circumstances. However, as Mr Authers suggests, the odds of a more negative outcome could well increase, resulting in market volatility. What do markets hate most?

The Economist published a fairly strong view to the effect that they are not expecting any increases in interest rates by any of the Fed, ECB or BoJ until 2020 at the earliest. If they turn out to be correct in this, we are reminded that it would underline the fairly difficult position that many investors find themselves in at the moment. Many interest rates in the developed world do remain very low, and investors really do have to think differently these days. With the above central banks operating at either negative or still close-to-zero rates, investors looking for income have to look that much harder to get good yields, and end up in many instances having to go out further along the risk curve than they envisaged. Some investors will even find it necessary to target sufficient capital gains to in effect provide the dividends they need, as problematic and unwise as this may be. Other investors will seek professional advice, and accept that their attitude towards risk will simply have to change - although with sufficient diversification and care there can still be solutions available. For instance, some research just out from Ashmore, the emerging markets investment specialists, suggests that Emerging Market bonds should be favoured over US High yield bonds. Indeed, the view of our Tactical Asset Allocation Committee (TAA) remains that riskier classes of fixed income offer a good spread for investors seeking above-average returns, and that on a longer-term view Emerging Market debt probably has a better risk-adjusted and yield profile than the US High Yield space.

Claude-Henri Chavanon

Managing Director
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'Just freezing oil production is not sufficient'

Last week was a very interesting one in the oil patch, with prices rallying strongly from a low of just above $26 (basis WTI), to just above $30, based on discussions between Saudi Arabia and Russia regarding possible output restrictions. The basic idea is to explore freezing oil output at January levels, with the proviso that other major producers should also join in. Iran - obviously important in all this - provided verbal support to the idea, without actually offering to join the initiative, with part of the background being that in raising their own production by a planned 500,000 b/d they will merely be re-claiming part of their pre-sanctions OPEC quota. Not only do various differences remain between countries in the MENA region, but in reality Iran would in reality find it very difficult politically to restrict exports, as with the end of sanctions its people expect oil production to increase, to the benefit of the whole country. In addition, of course, Iran needs investment to flow in from the international oil companies. Iranian oil production is thought to have been about 2.8 m b/d last year, vs. 3.6 m b/d in 2011, with exports last year falling to about 1.1 m b/d, approximately half of pre-sanction levels.

We remain of the opinion that, despite continued over-supply in the short-term, the oil market is carving-out a bottom. The nature of market action will likely continue to be jagged and highly volatile, and we believe it may take some months before we might be able to really think the price low is behind us. US oil inventories have increased further, to another all-time high, and US shale production is taking time to come out of the market. Just as investors might be tempted to put on trading positions close to $25, if they do so they should also continue to limit their upside target expectations, to between $37-40 (basis WTI) as an absolute maximum, for at least the next six months. It is not simply US shale oil producers who would look to maximize revenue under that scenario. Clients should be looking to 'Buy the dips' in crude oil. Our 2016 forecast trading range remains $25-$45.

'We remain on the sidelines in Chinese equities'

There were a few news items out of China last week - and it wasn't all bad news. Firstly, there was a relatively encouraging inflation report, showing that Chinese consumer prices rose 1.8% year-on-year in January, vs. 1.6% in December. Additionally, wholesale prices fell year-on-year in January by 5.3%, a good moderation from December's 5.9% fall. In both these instances, analysts have sited the earlier timing of the lunar New Year this year, together with rises in food prices as factors. Although it could be premature to call the bottom in Chinese inflation, it seems strange that we are still reading reports regarding the 'risk of deflation in China', and we will be monitoring this closely to see whether there was indeed a 'lunar' blip. Elsewhere in Chinese news flow, it was interesting to see that the head of the country's securities regulator has been replaced, following the stock market fiasco of last summer and continued securities policy mis-steps since then. Meanwhile, the Governor of the Peoples Bank of China has said he sees no basis for persistent depreciation of the renminbi. In investment terms our TAA house view on Chinese equities is to remain firmly on the sidelines, due to the lack of transparency in markets and a feeling that PBOC policy has been muddled during recent weeks and months.

Last week saw intense negotiations regarding Britain's relationship with the European Union, spear-headed by David Cameron, leading to an announcement over the weekend that the UK referendum on membership will be held on 23rd June. It is a fairly complex subject, but here is our take on what has happened, with help from the BBC. Firstly, in line with previously-stated policy, Mr Cameron has changed the legal EU wording to exempt Britain from 'ever closer union'. He has succeeded in introducing a 'red card' mechanism by which a 55% vote by national parliaments can veto a European Commission proposal. Regarding tax credits and child benefits (and the provision of social housing) to migrants, he had to compromise i.e. these will be phased-in over four years. Importantly, Mr Cameron determined that countries outside the eurozone, such as Britain, will (a) not have to fund euro-bail outs, and (b) they will be reimbursed for central EU funds used to prop up the euro. There are other clauses, but we should also mention that new promises were made relating to the cutting of red tape. So what does all this mean for investors, in the UK and elsewhere? In the weeks ahead we will be commenting on any significant twists and turns. For the time being we would refer to the findings of a pole organized by Woodford Investment Management a few days ago. They found that from a sample of 18,000 people, 'over half' expected a Brexit to have a negative impact, with 28% of respondents believing the impact would be positive. As we go to print, Boris Johnson, the Mayor of London, has come down on the 'Out' side, so a number in the order of 28% could increase slightly. On the face of it, common sense should prevail, however. Mr Cameron can probably say in all truth that he has secured a good deal, with a Brexit therefore not necessary. Sterling has already reacted negatively to this in the short-term, and in line with the currency view stated in our recent 'Outlook' we would be more inclined to go long cable on the basis that it is an 'outsider' that could pay off quite well this year after the referendum.

'It is becoming even clearer that Abenomics hasn't worked'

Japan's Nikkei 225 index rallied strongly during the week, by 6.8%. This appears to have been a technical bounce from a very depressed position after the recent Bank of Japan move to negative deposit rates back-fired badly (i.e. the yen strengthened rather than weakened), with the prospect that if yen strength was maintained, corporate export earnings would be severely affected. The yen corrected back downwards, at least partially, sparking a rally in stocks. Japan had some poorly-received January trade figures last week; exports fell 12.9% year-on-year in January, vs. a fall of 8% in December. Turning to imports, these were down 18% year-on-year, similar to December, confirming a big picture of weak or almost non-existent growth. There is an increasing sense that Japanese quantitative easing has reached the final end of the road, that quite simply it (and Abenomics) hasn't worked. In the meantime, we note further comments from the BoJ that there is 'no limit' to monetary easing as far as they are concerned. We believe that taking deposit rates negative has been interpreted as a sign of weakness, and that the BoJ has run out of options. Last week the yield on 10-year Japanese Government bonds went negative for the first time. The view of our TAA is to be bearish of the yen in favour of the US dollar, hence our remaining 'neutral' Japanese equity position (recently reduced from overweight due to excess volatility) is fully hedged. As per the review of Japanese equities provided in our 'Outlook', we very favour a 'value' tilt in this asset class.

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