From West to East

Weekly Investment View

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Trimming risk with the US Fed in Serenity

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The S&P500 edged ahead by 0.3% over the week, which was dominated by a significant increase in expectations that the US Federal Reserve may increase the Fed Funds rate by 25 bps next month, after publication of a hawkish set of FOMC minutes from its last meeting, as well as various Fed officials making public statements consistent with that (and suggesting at least a further increase after that before year-end). Pricing in the futures markets now suggests a 34% probability of a rise next month, up from as low as 4% a few weeks ago. Eurozone stocks gained 1%, and Japanese stocks rose 2%, helped by a slightly weaker euro and yen. The underlying tone of most markets was 'risk-off', with gold, US Treasuries and German Bunds eventually attracting some haven buying. Consistent with the FOMC's more hawkish tone, the dollar firmed in terms of its index, which gained by 0.8%, back up to technical resistance just above 95. Oil prices rallied further, by 3.3% on WTI, and 1.9% on Brent, with $50 for Brent looming. The latest Baker Hughes report said the number of oil rigs operating in the US at the end of the previous week was unchanged, following 10 weeks of falls (so it looks as though fewer tight oil rigs have come out of operation with oil prices firming). Also, OPEC said it produced 32.44 million barrels/day in April (+188,000 on March), the most since 2008. Supply issues as well as political uncertainty continued to drive the oil price higher last week, which still looks capped for the time being at just above $50. ***After increasing our average price assumptions for this year and next last week, we now expect a $36-$50 range on WTI with $60 possible late in the fourth quarter.***

'The Fed would love to get ahead of the curve'

It is well-known that the Federal Reserve intends to normalize interest rates whenever continued strength in US economic data allows – US rates have been maintained at very low levels for a very long period of time. Many commentators believe that US economic data remains encouraging overall. US economic growth has remained below its potential, however, with patchy retail sales along with weaker manufacturing numbers exacerbated by a stronger dollar compared to a few years ago. Having said that, the employment numbers have improved, and wage growth has continued to tick upwards. This perhaps is the first indication that the Federal Reserve's inflation goal of 2% may be met in coming quarters. The hope is that what begins with improved earnings for the average US worker will eventually spread to other parts of the economy, provided the savings rate doesn't continue to rise too much. The Fed may well look to raise rates as a pre-emptive strike to balance the possibility of any unwarranted sharp rise in inflation, and as an attempt to 'get ahead of the curve'. Any genuine recovery in commodity prices, including crude oil, could feed through quite quickly into inflation, and despite US growth expectations remaining low and having been subject to recent downward revisions. ***Outflows continue from equity markets globally, with current uncertainties, but this is likely to lead to opportunity in selected markets. Having said that, our house view remains neutral in US equities: we are cognizant that sentiment is already very bearish, and cash on US corporate balance sheets remains very high. The generally low interest rate environment along with global QE continues to drive the market. The committee maintained its stance of being 'neutral' in US equities.***

Elsewhere in US economic statistics, CPI inflation for April was boosted by higher energy and food prices, increasing by 0.4% as the prices of gasoline and rents rose, taking the year-on-year increase to 1.1% (vs. 0.9% in March). The 'core' CPI, ex-food and energy, rose 0.2% on the month, after 0.1% in March. Over the 12 months to April, the core CPI increased by 2.1%, (vs. 2.2% in March). However the Fed's preferred measure of core inflation stands at 1.6%. In other data, US housing starts and industrial production was seen to have rebounded strongly last month. ***The evidence is that underlying core inflation appears to be firming, and this is supportive of the Fed raising rates.***

'We cannot regard the Japanese GDP improvement as sustainable'

Japanese real GDP expanded at a 1.7% annualized rate in the first quarter of the year, exceeding market expectations for a 0.3% rise. Consumer spending was helpful, adding an estimated 1.1% to growth, and a technical recession was avoided, at least for the time being. The discussion regarding whether Abenomics can succeed is ongoing. We have seen various periods of positive Japanese 'economic surprises' in recent years, although these have always reverted back below zero. ***Japan's structural headwinds continue to look substantial.*** **The committee remains 'underweight' Japanese equities.**

Sterling firmed by almost 1% against the dollar, during a firmer week for the latter. Polls showed the spectre of Brexit receding. Bookmakers commented that more than 90% of bets placed in the last week have been for the UK to remain. Bloomberg says that according to Good Judgement Inc.'s panel of 'superforecasters', there is now only a 23% chance voters will choose to leave the EU. **Bears of Sterling appear to be covering in recent weeks.**

'We know that Chinese equities will be more important after MSCI moves'

Looking at the recent flow of economic statistics out of China, these have mostly been below expectations, and consistent with a planned economic transition that is not smooth (was it ever going to be?). However, looking at recent news, such as the intention of the Chinese regulators to restrict trading halts, China is doing many of the right things to help ensure the country's so-called 'A' shares will be included in the all-important MSCI global equity indices, albeit gradually. ***We continue to follow the Chinese equity market with great interest, even if currently from a 'sidelines' perspective, and don't want to be left behind once positive MSCI news occurs. China is not about to go bust.***

The Tactical Asset Allocation Committee met last week, and decided to reduce the remaining overweight positions in Emerging Market bonds and equities to neutral, with the proceeds allocated to cash while booking profits on our successful call highlighted in previous communications over the weeks. Uppermost in the mind of the Committee was that just the summer season alone brings the increased likelihood of volatility in what typically become very thin markets. The central emerging markets thesis remains very much intact, however, and the Committee will be constantly monitoring these markets in the months to come to see if positions can once again be added to at lower levels, once the investment outlook becomes clearer.

'Our high-conviction ideas for the week are higher-yielding equities in developed markets, and US financials'

With monetary easing measures continuing around the world, especially in Japan and the eurozone, we believe that good opportunities exist in quality high-yielding dividend equities. It is still possible for institutional investors to take advantage of a 'carry trade', borrowing funds at these historically very low rates and investing them into higher-yielding assets, some of which can be considered blue-chip in nature. Within the developed market space, European stocks are much better value than their US and Japanese counterparts. European-based QE by definition especially benefits the safer, high dividend plays in European equities. Accordingly, clients would do well to focus on this area while these policies prevail. Generally speaking, if investors target stocks with dividend yields of up to about 25% greater than the relevant broad index, they can do well - the reason being that such stocks are often 'unloved', although tend to be quite safe. ***Only by targeting very high dividend paying equities do investors risk the prospect of excess downside risk resulting from the possibility of cut dividends; high-yielding equities come into their own during the kind of investment environment that we could now be entering, as many of them are already structurally cheap.***

In a period of rising US interest rates - especially if gradual, as continually suggested by the Fed - a major beneficiary is likely to be US Financial equities. Banks in the US have found it very difficult to make money on the margins they lend on, anchored by interest rates that have remained near zero for some time. US Financial valuations look cheap in relation to profit expectations in a rising rates scenario, in which the 'endowment' effect comes back into play for them i.e. they are able to increase lending margins. Also, time and again over the cycles, investors and analysts get too worried about the effects of banks having to provide against bad loans, or discount further and further shrinkages in lending margins, only to leave the sector fundamentally cheap as the interest rate cycle turns. For the year-to-date, it is Financials (and Health Care) that have been the US equity sectors most hammered, vs. the Utilities sector, which has stood out to the upside. ***The anticipated sector rotation in favour of Financials makes fundamental and technical sense to us, bringing the likelihood of absolute gains in this oversold sector.***

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