NBAD

From West to East

Weekly Investment View

23rd October, 2016

Healthy Balance Sheets Buoy US Markets

Last week the S&P500 rose by 0.3%. Cash levels remain high on US corporate balance sheets in the continuing low-interest rate environment. Stock buybacks maybe giving way to corporate takeovers. British American Tobacco is making a $47 billion offer to acquire the 58% of Reynolds American that it doesn't own, while in the telecoms sector AT&T is reported to be in advanced talks to acquire Time Warner, which could cost in excess of $74 billion. Elsewhere, Microsoft went to a new all-time high following an earnings beat driven by its success in cloud computing. Irrespective of whether US equities are fundamentally cheap or dear (we believe as a market they are fully-valued), there are large amounts of cash available to maintain many stock prices at full valuations. Having said this, earnings results in the current reporting season have been mixed, and a strong dollar would be problematic for exports and foreign earnings translation. Investors need to await the outcome of the Presidential Election to gain more definite insights regarding likely sectoral rotation.

'Trump: latest opinion poll could upset the Clinton apple cart'

In US politics, Donald Trump is judged by most pundits to have 'lost' the third and last Presidential debate, although in many ways his performance was better - but still not good enough. A day or so afterwards the probability of Ms Clinton winning rose to a new high of 93% on the New York Times 'Upshot' model that we have been following. Fast forward to this morning, however, and the latest Investor's Business Daily (IBD)/TechnoMetrica Market Intelligence (TPP) opinion poll (apparently described as the most accurate poll in the last three presidential elections) shows Trump leading Clinton by 41% to 39%. So the polls are still not helpful, while we know that Clinton would have to be ahead by a large amount to substantially reduce the chance that a late tilt towards 'Populism' could come to the fore and usher-in Trump. So the point is that in reality - and despite all the dice being stacked against Trump - as investors we still have to hedge ourselves against the result that Wall Street has already written-off. At the same time, the consensus suggests that the House of Representatives should keep its Republican majority, while the Senate appears to be up for grabs - but upsets in the House look possible, too. **So investors should keep their hedges on, whether they are cash, or gold, or short duration in bonds, in addition to staying diversified across asset classes and with a strong tilt towards quality as we cannot predict the outcome of the election.**

Last week Mario Draghi announced that the door was left open on ECB monetary policy with respect to interest rates. Following his comments after the meeting the markets decided that the ECB's QE could well be extended beyond March 2017, when the current programme is due to end. The question of 'tapering' has been speculated upon by the markets over recent weeks, with no statements or references made to this definitely happening. The Euro sold off as a result. Our Asset Allocation Committee met last week to discuss this very point and pondered removing the long dollar/short euro hedge. Instead it was decided to leave it in place once the announcement of Draghi's comments had been made. He hinted at the possibility of more stimulus, including extending its QE programme, perhaps in December. He stated QE would not end abruptly, without tapering it first. A further hint was that he noted that there was no "convincing upward trend" in inflation, which has been dogging the Eurozone throughout recent years. Mr Draghi is a master of keeping the markets guessing, facilitating the deferral of policy decisions when necessary. As a result, the euro/dollar pair ended the week on the downside, at 1.0884, and looking as though a return to the 1.06 level shouldn't be ruled out. Eurozone data over the months has been an improving, however, despite the lack of inflation, but has not been sufficient to convince market participants to be bullish on the Euro, especially in the face of various elections due in the coming months. The AA Committee remains fully hedged against both Euro and Yen weakness.

Claude-Henri Chavanon

Managing Director
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'Saudi Arabia: Maiden sovereign issue gets airborne successfully'

Last week's successful first ever issuance of Saudi Arabia sovereign debt was greeted very well by international investors, who took $17.5 billion of 5, 10 and 30-year paper, and at lower spreads than originally envisaged. The issue was over-subscribed by at least three times. There was an impressive take up by a very large institutional investor base with good participation by Asian players in particular. The 10-year tranche was priced at 3.25%, 30 bps above the comparable Qatar issue. The 5-year was placed at 2.375%, and the 30-year at 4.50%. All three tranches had tightened from initial price guidance that surprised many. To all intents and purposes this was precisely the issue investors were looking for out of the region. A maiden sovereign bond by the Kingdom, that had already raised $63 billion in local currency debt, and $10 billion from bank loans this year. The two previous fund raising exercises went some way to funding a fiscal deficit expected to be around USD $97 billion, equivalent to 15% of GDP, very high for any country. The investor base that took up the issue sought more longer dated paper, a requirement for sovereign wealth funds who seek long term, steady yields, as well as large insurance companies seeking to match their long-dated liabilities. The success of this issue is truly significant for the MENA bond markets generally, as it goes a long way to stamp out concerns about an imminent Riyal devaluation or indeed liquidity issues facing the banking sector there. Unless oil prices unexpectedly plunge, or regional tensions take a new negative turn we think this sets the floor for Saudi markets in a much needed reprieve for the Kingdom after a torrid year that saw Saudi sovereign credit default swaps (CDS) trade as high as 180 basis points from the low point this summer after the oil price crash of last year.

This Saudi Arabian sovereign issue now sets a benchmark curve that should start seeing quasi-government and high profile Saudi corporate issuers coming to the market. Of course these tranches will be very helpful for Saudi's more highly-rated neighbours, who will have looked on with great interest. The issuance was also helpful to local equity markets, which have suffered from Saudi Arabian-led equity weakness, the latter having been one of the world's worst performing equity markets in recent weeks and months. The Tadawul index rallied by 2.3% last Thursday, helped by most of Saudi's bank stocks, and from what we can now describe as very oversold levels. 5-year Saudi CDS traded down further, in improved risk sentiment for the country, moving 10 bps lower, to 132 basis points.

'The early dawn of the Saudi 2030 vision?'

The advent of Saudi Arabia's National Transformation Plan 2030 led to high expectations for action, and there seems little doubt that the kingdom is very serious about realizing its economic diversification (and social) aims, leading up to what will be the world's largest-ever IPO in Saudi Aramco expected sometime next year. Wage cuts in the massive public sector have taken place, subsidies have been cut, and government spending has been slashed in order to deliver much-improved fiscal discipline. Unfortunately, these spending cuts have engendered significant negative multiplier effects, while also further contributing to extreme tightness in local money markets. Let's not underestimate the scale of what is happening here. If externally-held debt is estimated at about 8% of GDP now, it may not be problematic for this to expand to 30% by 2020, as seemingly envisaged. Commentators have noted, however, that earlier this year the IMF expected Saudi's fiscal break-even oil price to fall to $66.70 (from $92.90 in 2015), whereas they now estimate this at $79.70 for the current year. It will take a period of years for a truly-functioning non-hydrocarbon economy to be created in Saudi Arabia, and this in a part of the region adjacent to such problem areas. The changes underway are significant, and investors will want to see genuine tangible results over the medium-term.

Turning to oil, the price of WTI was little changed over the week, closing at $50.55. On the charts (which can often be self-fulfilling over the short-term), there appears to be excitement building that a successful test of a possible 'neckline' (at about $52, and derived from trading over the last year or so) is imminent. According to Bloomberg, Brent and WTI futures speculative ('non-commercial') net positioning is at about a five-year net-long high, so traders have already gone long. Meanwhile, it is helpful for oil bulls to see that the US Energy Information Administration (EIA) last week said that in the week ended 14th October US crude supplies fell by 5.25 million barrels, vs. expectations for a 2.1 million increase. They expect output at major US shale plays to fall 30,000 barrels/day in November, to 4.43 million b/d, from 4.46 million b/d in October, which is less helpful as it's not very much (and could easily reverse given a few months of higher prices). The EIA also reported that US crude inventories fell for the sixth week in seven, to 468.7 million barrels, music to the bulls' ears. Of course it's easy to get carried away with these statistics, mainly because they are more reliable than from many other producers. In the background investors are looking to the OPEC meeting due in November, but perhaps are due for a reality check given that the devil is still in the detail regarding output cuts, and also considering that most producers (and Russia) have already maximized production. A round-up of supply comments suggest that producers, from Libya and Iran, to Brazil, are increasing production and that producers are more-often-than-not successfully reducing costs. Just as Saudi Arabia used to be the 'swing producer', this is now the shale producers in the US. In summary, although we still expect to see $60+ oil in the first half of next year, we need a bit more fundamental evidence that the re-balancing is accelerating, and believe the technical bulls will have to be patient for a while longer.

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