NBAD

From West to East

Weekly Investment View

24th July, 2016

Markets travelling hopefully

The S&P500 crept to yet another record close at the end of last week, to 2,175.03, up 0.6%, eclipsed by the NASDAQ Composite, which closed up 1.6%. It is too early to tell, but the latter could represent the beginning of an encouraging sectoral rotation away from utilities and staples. Elsewhere, the ECB left rates unchanged, following the Bank of England the previous week, looking for more evidence regarding economic conditions on the ground following the Brexit vote. The situation in Turkey was still of concern to many as the week ended, with tens of thousands of people either arrested, sacked, and/or subject to travel restrictions. Eurozone equities closed the week 0.6% ahead, with Japanese equities up 0.8%. Quality sovereign bonds were little changed over the week, with the US 10-year Treasury yield up 1 basis point at 1.57%, and the yield on 10-year German Bunds 1 basis point lower, at -0.08%. The major currencies were essentially stable over the week, although if anything with some continued dollar strength. Bank of Japan Governor Kuroda made it clear he wasn't in favour of so-called 'helicopter money', with the markets seeing the yen strengthen off recent lows above Y107. The price of WTI crude traded lower, to just below $44, towards the bottom of our forecast intermediate range of $42-55, largely on the basis of a continuing glut in gasoline in the US, and a continued gradual increase in the Baker Hughes rig count, as well as indications of some recovery in Iraqi production.

'Estimates of earnings on the S&P500 are moving up'

At the end of last week US second quarter results were looking fine so far (about 25% of companies have reported). The FT quotes FactSet, who have said that results so far are ahead of expectations, and now on track for -3.7% in net profits year-on-year for the quarter, compared to a forecast 5.4% decline at the end of June. Another commentator, however, said that on average over a long period, 66% of results exceed expectations, and the 2Q results to date stand at an average 'beat' of 63%. On an individual basis, Microsoft was a good beat, IBM was a reasonable beat, while the market wasn't impressed by Intel or Starbucks. The ultimate arbiter, for the time being, has to be that the S&P closed at a new all-time high, and with the NASDAQ Composite having recovered to the 5,000 level, a significant chart-point. We suspect that analysts will be proven to have been slightly too pessimistic on earnings for the quarter just gone, and this is backed up by estimate revisions for the current year for the S&P500, which now suggest earnings growth of 9.30%, up from 8.86% just a few weeks ago. Last week's announcement of Softbank bidding for ARM Holdings, and Verizon's mooted deal to buy Yahoo's core business are examples of just a small amount of available corporate cash coming off the sidelines.

Investors have been looking to the world's central banks to continue to provide liquidity to the economic system, as we know. The ECB last week left rates unchanged, however, pending further evidence of the economic effects on the ground from recent political developments, in a similar response to the Bank of England leaving its rates unchanged the previous week. The markets took further Mario Draghi 'we will do whatever is necessary' comments in their stride. We think the ECB (and certainly its Bundesbank 'wing') would rather avoid going further down the negative rate path if this can be avoided. With the ECB QE rules the way they are, the amount of asset purchases have to be in line with the size of each economy, so (according to the FT) Germany's Bundesbank has to buy around €10 billion of German government debt each month, but they are now running out of allowable German bonds to buy at prices that make sense and whose average yields are not negative. We have underlined in recent weeks that the move in the 10-year Bund yield below zero could very well represent something of a watershed in bond markets - genuine roundaphobia, almost.

Claude-Henri Chavanon

Managing Director
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'Events in Turkey have been bad, but not disastrous'

Turkey's President Erdogan may have successfully crushed last week's coup attempt, but he and the country are not out of the woods yet. Tens of thousands of people have been arrested, sacked, or had their travel blocked. Economically, things have suddenly become more challenging. Turkey, typically heavily reliant on foreign direct investment, had already seen large outflows which have just accelerated. This has had a knock-on effect on the Turkish lira. The current account deficit has widened to 4.5% of the country's GDP, and this will get much worse before it gets better. The tourist industry has recently suffered from the airport bombing last month, which has also been affected by volatile relations with Russia since the downing of the Russian jet. Ratings agency S&P immediately downgraded Turkey to 'BB' with a negative outlook, such that if the situation deteriorated further it could lead to a further downgrade, and Moody's also acted in a similar fashion. Unsurprisingly, Turkish equities fell by about 13% last week. To what extent have markets factored in the bad news? Of course it is very difficult to tell. In the event that Turkey's relationship and role within NATO were to be affected, this could be serious, especially as Turkey has been key in the fight against IS. Much will be played-out in the weeks and months to come. We continue to monitor events very closely. Oftentimes markets will over-react, however, providing opportunities for nimble investors whose levels of risk aversion are above average, or the nature of their investment mandates teach them how to take such events in their stride.

As we go to print, Hillary Clinton has a 76% chance of defeating Donald Trump to become president of the US, according to the New York Times' presidential race tracking model. This suggests Mrs Clinton is the strong favorite in 14 states and the District of Columbia, which would be sufficient to give her 186 of the 270 electoral votes needed to win the White House. There are apparently about eight other states that are leaning more towards the Democrats, which would give her a total of 275 electoral votes, handing her the presidency. Of course much can change: Bill Clinton came very much from behind to win in 1992, and we know only too well that 'upset' results have become more likely in the more populist world we now live in. Very recent polls suggest a 3-4% win for Mrs Clinton, although this is within the margin of error. We will be studying what comes out of the Democratic Convention this week, following the anti-Clinton vitriol that came out of the Republican National Convention last week. By their own admission, the New York Times says their 'Upshot' model is slow to move, as it attempts to take out short-term background noise from the analysis, although they accept that much change is possible. We think the long list of absences from last week's Republican convention show that many grass-roots GOP members have thrown their hands up and are wondering at the truly sad state of their beloved Party; they are probably quietly resigned to a loss - but they harbour hope for a win in 2020 following Clinton's probable single term in office.

'Nigeria is still between a rock and a hard place'

Last week the Nigerian naira weakened 3.5% to a record 294.5 versus the dollar in the spot market, following a fall of just under 30% vs. the dollar last month after the end of the currency peg that had been at 197-199 to the dollar. Inflation in Nigeria increased to 16.5% in June, almost a ten-year high, exacerbated by the above currency pressures, and at a time when oil revenues have been weak due to lower prices and the acts of militants in the Niger Delta. The IMF expects the country to suffer economic contraction of 1.8% this year, and 1.1% for 2017. Exporters of many items have been prevented from using the hard currency interbank market, forcing them to use the unofficial market, where the naira is currently trading at about 365 to the dollar. Insurgents continue to seriously impact Niger Delta oil production. This has not abated, and of course the army has its hands full fighting Boko Haram in the north and north-east of the country. The Nigerian government announced yesterday that it has entered into initial talks with militants in the oil rich Niger Delta region in an attempt to end the ongoing attacks on the country's key oil facilities and pipelines, yet these talks have not been confirmed.

STRATEGY SUMMARY:

Early last week our Asset Allocation Committee (formerly the TAA) met, and agreed to (1) continue with the overweight in the US equities, and (2) to go overweight in High Yield (HY) bonds. The US equity market has already been covered sufficiently above. Regarding the HY sector, the benchmark index used is the Bloomberg US Dollar High Yield Corporate Bond Index, whose yield is currently 6.64%. While global HY bonds are individually yielding what they do for a reason, this yield derived from a diversified list of bonds still looks too high in a low interest rate world - and still in the event that quality sovereign yields were to back up. The fact that the S&P is creeping to new highs is also supportive of the logic of overweighting HY bonds.

Early last week the IMF cut their estimate for worldwide growth to 3.1% this year, and to 3.4% in 2017, both 0.1% points lower than contained in their April report. Interestingly, the IMF was supposedly on the verge of revising upwards its global growth forecasts immediately before the Brexit vote, but the shock result spoiled that. In line with what we said a few weeks ago, the IMF have said they don't expect much direct negative impact on the economies of the US or China from Brexit. We believe that infrastructure spending is coming back seriously as a theme for investors to benefit from. We identified the likelihood of such fiscal stimulus a couple of years ago, only for the theme to then disappoint in 2015 - but now it's back, and with China in the vanguard. Today, the G20 finance ministers finished meeting in Beijing, although did not issue details of any joint initiatives, and talking in terms of wanting to see a mixture of monetary and fiscal policy, with reforms, to achieve 'strong, sustainable, balanced and inclusive growth objectives'. They wanted to reduce the spread of trade protectionism, and to see the UK leave the EU in as constructive a manner as possible if it finally did so.

We are generally taking a more optimistic view of global equity markets, within the context of remaining well diversified across the main asset classes.

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