NBAD

From West to East

Weekly Investment View

29th February, 2016

Staying safe – yet being tactical

Most developed equity markets closed between 1-2% higher last week, mainly led higher by rallying oil prices. Looking at the big picture - in a real sense polarized between the US on the one hand, and China on the other - our Tactical Allocation Committee (TAA) remains happy to be underweight in global equities, led by an underweight in US equities. We would refer you to the FT's John Authers' 'Long View', in this week's FT Weekend, in which he fully explores one of our favourite subjects i.e. what is actually happening to the rate of underlying earnings on the S&P500, and the increasingly questionable quality of them. For instance, looking at the current P/E, the Bloomberg consensus suggests a multiple of 17.3 x, whereas Mr Authers highlights that after a 'GAAP' (generally accepted accounting principles) clean-up, the true P/E could be closer to 21.5 x. We would caution investors against getting tricked back into US equities as a class. ***The continuing downward direction of earnings revisions, the US Presidential election, and (paradoxically) the probability that the dollar has yet to peak still suggests lower stock prices and underlines the poor value in US equities as a class.***

> *`It is worth standing aside during the US Presidential fight'*

Next week sees the crucial 'Super Tuesday' US primaries to be held in 11 states. Hillary Clinton (who is now not looking such a bad option) is now doing better, but Donald Trump, on the other hand, is continuing to roll with the punches and is bouncing back following the views of Marco Rubio and others expressed last week, together with various accusations made against him. Mr Trump's gaffes don't seem to affect him whatsoever. Like others, we will follow the results of next Tuesday closely. ***Some 'bad' results on Tuesday could have some major adverse short-term consequences for the markets.***

In the seemingly more objective area of US economic data, there was some relief that economic growth in the fourth quarter of last year was confirmed as having been at an annualized rate of 1.0%, above a previous 'flash' of 0.7%, and vs. expectations of a downgrade. Let's consider, however, that a 1% annualized rate is only that. Expectations of growth for the current quarter appear to be in a range of 2-2.5%, yet even if these happen to be realized that will make the expansion very, very long in the tooth by then. Meanwhile, the PCE (personal consumption expenditure) deflator, ex-food & energy, the Fed's preferred measure, came in at 1.7% on a year-on-year basis (vs. 1.5% in the previous month), therefore approaching the Fed's 2% target level. With this, the Fed funds futures market, according to Bloomberg, is now pricing-in a 32% probability of a 25bps hike this June, and 49% on one for December. The policy-sensitive two-year Treasury Note closed at a yield of 0.80% last week. We would still suggest rate rises are more likely to occur at the beginning of the next economic cycle, rather than towards the end of the current one. ***We are still of the opinion that the 10-year Treasury yield is more likely to trend downwards (from 1.76% currently), rather than upwards. Bond investors can safely add to their positions in US Treasuries.***

> *'China could still increase its level of fiscal stimulus'*

Claude-Henri Chavanon

Managing Director
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Press comment coming out of the G20 meeting in Beijing has underlined the differences between the world's important economic policy-makers, rather than any similarities, and in a real sense underlined what some of us have been thinking for some time. For instance German's Finance Minister, Wolfgang Schäuble, was quoted thus: "The debt-financed growth model has reached its limits". He doesn't support the use of fiscal stimulus (despite being one of the only governments that could afford this, as well as China), and would rather see reforms instead. He apparently went on to say that monetary policy had been extremely accommodative, yet may be counter-productive in terms of the negative side-effects on banks, policies, and growth. Mark Carney, the Governor of the Bank of England, similarly criticized negative interest rate policies, in very eloquent terms. Drawing a line through the above, perhaps the most disappointing aspect for us is the apparent unwillingness (not just the financial

inability) of most governments to switch the emphasis from monetary to fiscal policy. It is beginning to look as though China may have to come to the rescue (again), and despite the current pressures that currently exist in its own economy. The IMF has said it expects to be reducing its current year global GDP forecast of 3.4%. China may yet decide the risks of 'pump-priming' the world (or at least certainly the Far East) could be worth it in terms of overall multiplier effects that flow back.

Oil prices had a very good week, closing 8-9% firmer over the period, with for instance WTI closing at $32.78. There seems to be some residual hope that some kind of production limitation deal might still be possible, despite the dampening comments from Saudi Arabia's oil minister, Ali al-Naimi and others. In reality, investors have been much more concerned with the effects of current supply disruptions in Nigeria and northern Iraq, and involving pipeline complications in Turkey, affecting perhaps 800,000-900,000 b/day of production. For years we have known that the potential sources of oil market disruptions can be many and varied, and possibly serious if they occur at the same time. In our recent Outlook we suggested that further 8-12% price rallies were likely. Although it could still take some months for oil prices to definitively bottom, this kind of price volatility and market dislocation will help form that bottom. We have suggested trading what we see as a $25-45 range on WTI in the months to follow. ***What could pressure oil prices lower from current levels? One factor could be renewed dollar strength, while another could be a realization that perhaps only 10% of US shale production that came on in recent years is now being taken out. Traders should take short-term profits in oil-related investment vehicles with WTI just under $33.***

'We have a deep-seated view that the Brexit vote will produce a 'No' result'

In forex markets, cable (sterling/dollar) has fallen further, following confirmation that Mayor of London, Boris Johnson, is confirmed as having come down on the 'Out' side in the UK's 23rd June's Brexit vote. The UK once again finds itself in the position of having to endure a period of political and economic uncertainty, made worse by Mr Johnson's decision. We will spare our readers having to go through all the arguments as they come out, as coverage of them will be substantial elsewhere. On a 'strategic' view - and prejudiced by a genuine belief that the voters of the UK will vote 'No' in the end analysis (because it will be the safest thing to do - just as they voted for Mr Cameron in the General Election), we believe sterling could do very well upon a 'No' result. Last week sterling sliced through $1.40, and has recovered to $1.3871. Commentators are now busy talking it down much lower, well into the 1.20's. What will happen? It is clearly difficult to tell. ***One thing is certain, however: if sterling does see further downside, so will the euro.***

Lastly, the only change made at last week's TTA was to accept a recommendation to go overweight in quality Emerging Market (EM) bonds. In a general review of asset classes it was noted that the yield on the JPMorgan EM Bond Index (Investment Grade) had risen above 4.6% in absolute terms, vs. a high in recent years of close to 5%. While there may be nothing magical about that yield in particular, it does represent a sufficiently good spread against investment grade debt in developed markets. We said a few weeks ago that EM High Yield compared well in valuation terms with US High Yield (in terms of default rates, for instance), so we were pleasantly surprised to see the Investment Grade yield basis. Additionally, the JACI index (covering Asian bonds) is approaching levels suggesting that credits in that region are beginning to look cheap. Emerging market bonds witnessed some large outflows during the second half of last year, although these have now abated somewhat. ***Our view of developed market quality bonds should, if correct, be very supportive of return generation in the equivalent EM space. We reiterate that investors should selectively buy quality EM bonds.***

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