NBAD

From West to East

Weekly Investment View

29th May, 2016

Appropriate measures in a long slow recovery…

Last week's G7 meeting appears to have concluded with very little having been decided. Markets were more focused on what Janet Yellen said at Harvard on Friday night on the future path of US monetary policy. A Japanese attempt to talk the group into leaning towards renewed pump-priming was successfully thwarted, and the closing statement amended. The leaders agreed on the need for increased fiscal stimulus (the amounts to be decided by each country) to boost world growth that remains anemic. It was interesting to see both the 'EU' and France seated around the same table, underlining continuing political and economic differences. During her speech at the end of the week, Fed Chair Janet Yellen commented that a higher Fed funds rate looked 'appropriate' in the next few months if growth picked up and the labour market continued to improve. ***As a result markets leaned more towards a possible July rate hike, as opposed to a June one that was priced-in earlier in the week.***

'The heat is on when it comes to US rates'

Most developed world equity markets finished firmer over the week, led by the S&P500, which rose by 2.3%, closing 1.4% below its May, 2015 all-time high, led by technology, financial and healthcare stocks. Eurozone stocks rose 3.4% on the week mainly reflecting relief that Greece's debt problems continue to be pushed further into the future. In Tokyo, the Nikkei rose 0.6% in light volume. There was some disappointment that the Japanese yen continued to hold its ground, albeit finishing lower on the week. Earlier in the week oil prices briefly broke above $50, with WTI trading above Brent. Gold had a difficult week, as the market contemplated higher US rates, that with a stronger dollar put pressure on the metal. ***Bullish crude oil bets that took comfort from recent constrained supply side factors may have pushed prices a bit too far to the upside. OPEC's next meeting June 2nd along with the resurgent greenback saw increased forward selling in oil markets around the $50/ barrel mark and strike prices beyond in the oil options market. The latter is something we have highlighted in our views of recent weeks. We remain of the opinion the upside from current levels remains limited, at least for the time being.***

'Resurgent dollar kept in focus'

The Dollar index (DXY) gained 0.6% on the week, closing at its highest level since the end of March, spurred on by the comments from Janet Yellen and repositioning of dollar bears in previous weeks. Looking at Bloomberg's analysis, Fed funds futures have now priced-in more than a 50% probability of a move by the end of July, up from 17% a few weeks ago. **From our TAA point of view we have remained long US dollars as intimated in our calls.** ***The probability of a June move has retraced slightly, to just above 30%.The policy-sensitive yield on the two -year note closed up 4 basis points to 0.91% after a very successful auction, with the 10-year yield almost unchanged at 1.85%, reflecting the 'normalization' process of rates that the US is engaged in.***

In US economic data, US Q1 GDP data was revised, suggesting the economy grew by 0.8%, up from the previous estimate of 0.5%, that saw US assets rally further. While this is good news it still represents very lackluster growth. Clearly, this is now old data, and what will be important is to see whether current quarter GDP will show signs of further recovery as many economists have been expecting. Otherwise, data last week was mixed. New home sales surged by +16.6% month-on-month in April (vs. +2.4% expected) to 619,000 annualized, and the highest level since January 2008. The three previous months were also revised upwards. New home sales are about 12% of total home sales. Pending home sales were also strong during April, increasing +5.1%, (vs. expectations of +0.7%). Durable goods orders moved higher in April, increasing +3.4% month-on-month (vs. expectations of +0.5%), led largely by civilian aircraft orders. 'Core' durable goods orders (ex-transportation) increased by 0.4% (vs. expectations of +0.3%). US services PMI for May fell, to 51.2, from 52.8 the previous month, and vs. expectations of 53.1 that disappointed Economists. **We think that despite this weaker number the Fed will 'normalize' rates as highlighted when looking at employment and wage growth data with a pre-emptive rate rise that would ward off unwarranted inflation down the road.**

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'Uninspiring eurozone data; more temporary relief for Greece'

Turning to the eurozone, data released last week remained weak. Eurozone 'flash' manufacturing as well as the composite PMI slipped further this month. The provisional composite index was almost unchanged over the month, coming in at 52.9 (vs. 53.2 expected, and 53.0 prior). Splitting these components, the services reading was unchanged at 53.1, and the manufacturing index fell slightly to 51.5, vs. 51.7. The composite index looks consistent with annualized growth in the region of about 0.8%-1.4%. In Germany, the ZEW Indicator of Economic Sentiment dropped sharply in May to 6.4 (vs. expectations of 12.0, and 11.2 in April). The eurozone's recent weakness may in part be due to fears over 'Brexit' as well as industrial disruption in France that may have contributed to the data, as well as discord within Hollande's government. The market is hopeful of better numbers in the Eurozone as a result in coming months. ***Time to be brave we think. European equities look the most inexpensive in developed markets, and represent an opportunity based on current valuations.***

Last week, Greece's creditors said they had reached an agreement that will allow the release of €10.3 billion of emergency funding. The IMF made a concession that instead of direct debt-relief measures being approved now they would be approved at the end of the program. The fiscal problems Greece faces in effect have once again been pushed further down the road. Greece's parliament has approved new taxes and austerity measures needed to unlock these loans. Germany and the IMF, Greece's largest creditors, remain at loggerheads over debt relief. The IMF is realistic to say that debt relief is necessary. Short term medicine has been administered, again without the real cure being addressed. The IMF appears to have accepted that debt relief measures would not be in place until 2018, when Greece's current rescue package ends. ***So, at least for the moment, markets are likely to look the other way.***

'Japan cold-shouldered'

Turning to Japanese data, last week we saw a steep drop in imports that drove Japan's trade surplus to ¥823.5bn ($7.48bn) in April, the highest since March, 2010, paradoxically this has happened with the stronger yen. Not surprisingly Japan's exports fell for a seventh consecutive month in April, hindering Prime Minister Abe's efforts to rebalance the economy. Japanese PMI data fell further to 47.6, from 48.2 in the previous month. The really notable element in all the above was the 23% fall in imports, telling a story of domestic demand deficiency. In other Japanese data, CPI fell -0.3% year-on-year in April, down from -0.1% in March. Core inflation which strips out fresh food prices (a measure the Bank of Japan looks at in its 2% inflation target) fell -0.3% in April. This was flat from the previous month. In addition to the data, It looks as though Prime Minster Abe will postpone the planned 10% sales tax hike by 18 months. This after an initial increase to 8% in April 2014 caused a recession***. With this assessment, Our TAA model portfolios remain underweight in Japanese equities.***

'GCC Fixed Income continues to attract investors'

MENA fixed income new issuance last week continued to reinvigorate markets in the region. A slew of names tapped markets - Emirates Islamic Bank, Etihad Airways Partners, Axis Bank of India, and DP World, to name a few. Qatar Sovereign launched a multi-tranche issue, the largest GCC issue to ever come to market, following Abu Dhabi's successful issue a few weeks ago. On the whole, despite most tightening in terms of initial guidance on spread, appetite for them was good, showing investors still have faith in the region. With the recovery in crude oil, along with Ramadan starting next week it was good timing for issuers looking to tap low funding costs ahead of a potential US interest rate hike, as well as cash that had been sidelined by MENA investors being put to work in anticipation of these issues.

'Market Trumped?'

Donald Trump now has sufficient support to guarantee his Presidential candidacy, prior to July's Republican Convention with GOP support. The Republican party is just not what it used to be amongst traditional Republicans it seems. Trump is now neck-and-neck with Hillary Clinton in the polls. A Trump presidency has not featured in many 'what if-scenarios, as far as we can see. In terms of policy, he would spend money in his quest to 'Make America great again'. A successful businessman, some believe he would successfully re-boot growth, partly through infrastructure spending. Historically, a Republican administration has seen a resurgent US dollar. International views remain mixed about him, however. Originally, markets regarded Hillary Clinton as the 'least bad' option, but they are now faced with the possibility of a rather different outcome. ***Volatility come become elevated.*** Markets remain finely balanced, with the **VIX (the 'fear gauge' measuring the implied volatility on CBOE-quoted US equity options) has been moving in a narrower and narrower range, with the VIX trading at its lowest level since August last year.** With all the current uncertainties in markets, we anticipate some sharp moves in the immediate months to come. ***We would advocate being long volatility itself given its current low levels to protect positions.***