NBAD

# From West to East

## Weekly Investment View

9th April, 2017

# Not accepting the pessimism

**It was a week in the markets when events could have turned out badly (due to Trump's Syrian air strike, his meeting with President Xi of China, or the weak Non-Farm Payrolls posted for March) – but all ended calmly.** Popular 'safe haven' assets (the US dollar, gold, and the yen) rallied, but then stalled – for instance with gold failing to break important overhead resistance just above $1,260. Leading sovereign bond prices came off the top after a dip in the US 10-year Treasury yield to 2.27% intra-day, as risk aversion bottomed and reversed. While we accept that the Syria developments may have further ramifications (for instance the Russians threatened that relations between themselves and the US could have been seriously damaged), it was good to see much of the civilized world coming together behind Trump as he took decisive action and in an admirably 'presidential' manner. Russia, which continues to back Bashar Al Assad, had at least received some warning of the intended air strikes beforehand. **Russia (and Iran) look rather isolated after President Trump had taken the kind of unilateral action they had probably not expected him to - and the markets took all this in their stride.**

> *"Where have the dollar bears gone? We continue to expect steady gains"*

**The S&P500 index was down 0.26% over a week which showed at least some return to healthy (or 'normal') volatility, and closed at 2,355.54, still only 1.7% below its all-time closing high of early March.** The Euro Stoxx 600 closed 0.13% ahead over the week, helped by a weaker euro and no significant negative local political developments in the bloc. The price of WTI crude rose by 3.2% over the week, to $52.24, with its approximate discount to Brent increasing to $3, up from $2.24 at the end of the previous week, largely in response to the Syrian situation raising the geopolitical premium. Gold for a few hours looked as though it might break out to the upside – or so the bulls were hoping - reaching close to $1,267 at one point intra-day, but only closed ahead just under 0.50% over the week. The dollar firmed over the week by 0.63% on its index, to 101.18, as commentators (notably New York Fed Chairman, William Dudley) referred to the outlook for the Fed beginning to shrink its balance sheet before the end of this year - essentially a prudent reversal of the previous QE, money supply-boosting, process. Much was made mid-week of the space allocated in the minutes of the last FOMC meeting to this subject, which clearly remains under very active consideration. The dollar bears appear to have gone into hiding since the currency has regained its poise, and with the dollar index having held so strongly at the 99 level during the previous week. Coming back to the question of QE reversal, the Fed's balance sheet is currently in the region of $4.5 trillion, having been increased by bond purchases between 2008 and 2014 designed to keep interest rates at ultra-low levels to maximize the chances of preventing the economic system collapsing – and this compares to a balance sheet size of less than $1 trillion before the financial crisis. Dudley suggested that any reversal of QE would most likely be accompanied by a temporary slowing in the pace of rate normalization. Fed Chair Janet Yellen has time and again said that any shrinkage of the balance sheet would be conducted very slowly indeed, so as not to adversely affect the markets; accordingly, we feel that too much was made of this last week. Also, the Fed would not want to

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unnecessarily accelerate any rise in the value of the dollar. **We reiterate our bullish stance on the dollar, with the continued expectation it will appreciate steadily during the course of this year, and in line with the views expressed in Outlook 2017.**

**The US non-farm payrolls for March came in very much on the low side, with only 98,000 jobs being created, vs. an average expectation of about 180,000 within a quoted of 100,000-267,000.** In practice, 180,000 is the number that many analysts stay close to when they are unsure about what is going on, as it equates to a 'normal' rate of job growth in a moderately healthy economic environment. There were downward revisions for the previous two months, totaling 38,000. As is often the case, the weather proved to be a popular scapegoat. The headline unemployment rate fell to 4.5%, from 4.7% in February, to the lowest level in almost ten years, as mentioned by the FT, and lower than the market expectation of a maintained 4.7%. A tighter job market in theory means fewer payroll gains being possible, despite the existence of vacancies, yet economists (including Janet Yellen) have been bemoaning the fact that average earnings growth has not yet picked up by more. Average hourly earnings rose 2.7% year-on-year, marginally lower than the 2.8% year-on-year rate of the previous month. The average workweek was unchanged at 34.3 hours in March. Looking in a bit more detail, the retail sector has seen many jobs being lost during the last few months (consider how many department stores have come under pressure, especially from online purchases), with the FT highlighting that the sector lost 29,700 jobs in March. The labour force participation rate was unchanged at 63.0% last month, vs. a multi-decade low of 62.4% in 2015. We prefer to look at the so-called 'U6' number, the 'underemployment rate', including those working part-time who would rather work full-time job if possible, which fell to 8.9% from 9.2% in February. If this rate (in addition to the headline rate of 4.5%) were to fall much further, wage gains could be expected to accelerate. Otherwise, returning to the payrolls number, Goldman Sachs has estimated that weather-related factors probably explain about 70,000 of the difference in gains between February and March. The bottom-line is that we wouldn't pay too much attention to this data series until weather effects are deemed to have come through, and in addition would note that the NFP and average earnings are derived from two separate studies. **We still expect a further two Fed rate hikes this year as – of course notwithstanding a major shock – the FOMC continues to normalize; then and only then will they likely shrink their balance sheet.**

*"Disregard the recent weather-affected NFPs data; US growth looks fine"*

**In other US economic data releases last week:** the ISM Manufacturing PMI fell to 57.2 in March, from 57.7 in February, and in line with expectations. For services (i.e. about 75% of the economy), the ISM Non-Manufacturing Index (NMI) fell to 55.2 in March, from 57.6, and was probably below expectations. Taking the Citi US Economic Surprises index as an arbiter of recent data, although this has come off to just below 40 (down from just below 58 in the middle of last month), the rolling summation of data is still coming in above expectations. The services sector is the real driver of the US economy these days (manufacturing is thought to be only about 12% of GDP), and a PMI reading in the region of 55 is very heathy. Looking at how Trump Administration policies have been rolled -out so far, it has been a difficult start, although the Outlook 2017 had warned against expecting too much, too soon. Despite an admitted few moments of angst we have kept faith, and remain overweight in developed market equities, emphasizing the US and Europe (ex-UK). **As the title of this week's report suggests, we do not accept the pessimism of the bears. We would still like to see a moderate 4-5% correction.**

**Many of our readers will have been following events in South Africa, and the way these have resulted in quite significant pressure on the rand.** We refer to the latest views of our Global Markets Emerging Markets FX colleagues, who have said over the weekend that price action suggests that investors are trying to get out of ZAR (SA rand) assets given any opportunity to do so, or at least trying on put FX hedges in place. All immediate resistance levels were broken during the last two weeks, and they expect the rand to weaken further towards 14.50 (to the dollar) in the near-term, vs. Friday's close of 13.7590. At ground level protests gathered pace across the county's major cities calling for President Zuma to quit, following his recent cabinet re-shuffle. **As our colleagues observe, however, it does appear that he is not going anywhere soon, despite Fitch and S&P having downgraded their SA country ratings to junk.**

*"In China, we especially like the very high domestic savings rate"*

**We continue to have a serious 'watching brief' on Chinese assets.** It was interesting to see last week that China's foreign exchange reserves rose slightly to $3,009 billion at the end of March (vs. $3,005 billion at the end of February), according to the People's Bank of China, detailing that reserves increased for the second consecutive month. The central bank raised the rate for its standing lending facility, possibly hinting at further monetary tightening to come. In recent reports we have commented favourably on the way the Chinese authorities are increasingly doing more of the right things to manage their huge economy. The authorities have also acknowledged the difficulties in measuring GDP, for instance. In last week's report we said we expected good developments to come out of President Xi's meeting with President Trump in Florida, and although it appeared to result in more of a 'get to know each other' summit, by many accounts genuinely solid progress was made. No trade deals were reached, although China made it clear they will work on ways to achieve a better balance of trade between the two countries, and also on other issues. So much for politics and diplomacy, perhaps – although we are actually not surprised that reports have been positive. Both countries' Presidents realized there is a massive amount to be gained by constructive dialogue.

Behind the scenes the Chinese have already targeted Jared Kushner, son-in-law and senior advisor to Trump, having identified him as probably the very best conduit to the man himself. **Although we don't yet have a formal 'house' view on Chinese assets, we are continuing to build on the positive introduction that we provided in the Outlook 2017.**

**In recent weeks we have underlined our continued enthusiasm for MENA equities, with UAE equities being in the vanguard of this, again dating from Outlook 2017.** This has so far been a 'slow burn' in that the asset class did not appreciate almost immediately, compared to the way Indian equities have done after we recommended them at the depths of the 'demonetization' gloom. There isn't space to reiterate the whole story on MENA equities, but we would highlight the following: (1) Our own new bank, First Abu Dhabi Bank (still trading for the time being with the NBAD ticker) has been very well-received by analysts and international investors, and has in many ways itself pushed the whole asset class forward; (2) Fitch last week made it clear that Abu Dhabi is very well placed to weather oil prices at about $50/barrel, and so are Kuwait and Qatar; (3) S&P has affirmed its ratings on Saudi Arabia at 'A-/A-2' with a stable outlook. The stable-to-gradually upward trend in oil prices reflects a close trade-off between demand and supply factors, with in our view net positive conclusions: $60-65 for WTI still appears possible by the first quarter of 2018. **We reiterate our overweight stance on MENA equities. Next week we will review the positive developments that continue to evolve in MENA bonds.**

*"Trimming the Indian equities overweight; adding to the tactical underweight in sovereign bonds, and going overweight in High Yield"*

**INVESTMENT SUMMARY:**
**The Asset Allocation Committee met on Thursday last week, and made the following changes to house views:** (1) **Although the medium-term view on Indian equities remains overweight, it was decided to reduce that overweight on a purely tactical basis** (the strength in the rupee towards the 64 level vs. the dollar has also helped) as global investors have perhaps become a little over-excited in the short-term; (2) the fall in sovereign bond yields in line with short-term strength in the asset class as investors have believed the Trump trade has been damaged makes for a **tactical underweight in developed country sovereign bonds** – and in US Treasuries in particular. In essence, 'risk-off' mode in markets has gone too far; (3) in line with anticipating a return to more 'risk-on' in markets, **a new overweight in High Yield Corporate bonds is recommended.** This class tends to move in tandem with US equities, and is also helped by higher rather than lower oil prices, as well as being buoyed by the better out-turn on US and global growth that we expect for 2018. We have in recent weeks and months successfully traded the US Treasury 10-year 2.30-2.60/2.65 yield range, which we still believe to be intact. **Many commentators have been predicting an end to the 35-year global bull market in bonds, while we have said that is too soon, with a trading range likely to be in place longer than expected.**

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