NBAD

From West to East

Weekly Investment View

16th April, 2017

Easter ushers in heightened geopolitical risk

Global markets ended the week very much risk-off. The week started with an impromptu missile strike by the US aimed at insurgents in Syria. This was followed by the US also taking action in Afghanistan. By the end of the week US–North Korean tensions rose with US warships heading to the Korean peninsula in a warning to North Korea about further missiles tests being conducted. Furthermore, investors are now of course focusing on the failure of North Korea's latest missile launch over the weekend, and that the situation may have escalated had the launch succeeded. President Trump so far has 'no comment', with the Chinese being left in a difficult position, seen as a historical allie of North Korea. Some commentators have welcomed the fact that President Trump has begun to tackle the North Korean problem (neither the UN Security Council or President Obama had done so). In such situations of uncertainty investors were left concerned about where this all might lead. It would also be a shame if the apparent positive recent strides made in relations between the US and China were rolled back. **Having said that, we continue to expect positive engagement between the US and China, especially after President Trump deemed China not to be a currency manipulator, which had been a bone of contention.**

"Global geopolitics has contributed to greater volatility in markets"

The S&P 500 was 1.13% lower over the shortened trading week, closing at 2,328.95, 2.80% below its all-time closing high of 2,395.96 of the 1st March. A further notable event of last week was President Trump (in an interview with the Wall Street Journal) talking down the dollar, saying it was too strong, and also saying that he would like to see interest rates stay low. The dollar index closed 0.66% lower over the week, at 100.51. We expect that Steve Mnuchin, US Treasury Secretary, will once again get to grips with such a comment, just as he did a few months ago when he – quite successfully, we think – argued it both ways. Incidentally, Mr Mnuchin's first report to Congress on foreign exchange markets is due any week now, so it will be l be interesting to hear what he has to say. With quality bonds being in demand for many of the above reasons, the yield on the bell-weather US 10-year Treasury bond fell by a further 14.5 basis points over the week, to 2.2374% - down from a recent closing high of 2.6258% on the 13th March. Gold closed up 2.48% on the week, at $1,285.69, and above short-term resistance clustered around $1,264. In a similar vein, commentators were all week talking about how the S&P500 VIX 'fear' index had moved above the 11-12 level (it closed at 15.96 on Thursday). Although a significant short-term move, it has so far just moved back towards its historical trading range of 16-20. Also worth mentioning is that JPMorgan and Citi, amongst the first to report US first quarter results, both beat expectations, with higher net interest margins, as well as good securities trading volumes. In other markets, European stocks only fell moderately, with the Euro STOXX 600 index 0.18% lower over the week, helped by a weaker euro, and also probably by Marine Le Pen slipping in the polls. Japan's Topix index fell by 2.06%, pressured by a stronger yen and geopolitical concerns. **Oil prices were higher, with WTI closing at $53.18 (+1.80%), and Brent up by 1.18%, although this did not help the MSCI UAE index, which closed 1.29% lower on the week.**

Russia's President Putin decided to meet with the US Secretary of State, Rex Tillerson, after all, in all likelihood helped by the fact that in recent years the two men had enjoyed a good working relationship (while Mr Tillerson was CEO at Exxon Mobil) – and Tillerson's receipt of a 'medal of friendship' from Russia a few years ago probably helped at the margin. The lines of communication appear to remain open. Regarding China, the US Administration's decision that they are not to be labeled a currency manipulator is almost certainly based on Trump's realization that, following the Florida summit, there is much to be gained by having good relations with China, not only with respect to North Korea, but also as they are one of the two largest holders of US Treasuries. The Chinese

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central bank (PBOC) looks to have been supporting the currency (renminbi) for a number of months (to counteract cash outflows). Indeed the People's Bank of China may now be quite happy with where the renminbi currently trades versus the dollar, following the net benefit that has already accrued from renminbi depreciation in recent years. Trump's critics have naturally used his change of tack here to say that he has failed to deliver on a promise made in the US election campaign, and similarly that his conclusion of last week that NATO is not obsolete after all is a further example. **Trump policy continues to be tweaked from his initial manifesto pledges on Twitter to more concrete decisions.**

"The US Consumer Confidence index looks constructive, and should drown-out other data"

Turning to US economic data, the jobless claims for the previous week ending 8th April fell unexpectedly. Initial claims for unemployment benefits fell 1,000, to a seasonally adjusted 234,000, the third decline in a row, and compared to expectations for an increase to 245,000, and quite close to the 44-year low achieved in

February. We agree that this maintained low level of claims is consistent with the view that March's low non-farm payrolls (NFPs) number was likely an anomaly and that the labour market is still tightening. March retail sales posted a 0.2% fall, following a 0.3% fall in February previously reported as an increase, and vs. expectations of a fall of 0.1%. Downbeat sales reports from the major auto manufacturers had suggested a weak auto sales component, and these posted a fall of 1.2% month-on-month, vs. a fall of 1.5% in February. Also, as Bloomberg has commented, lower auto fales will have adversely affected the number. Headline March producer prices fell by 0.1%, vs. expectations for no change, and after a 0.3% increase in February, reflecting a fall in the cost of services and energy products, although the year-on-year change was 2.3%, following 2.2% in February, suggesting underlying pipeline inflation has edged higher. The 'core' PPI (excluding food and energy) increased 0.3% in February, and was up by 1.7% year-on-year, compared to 1.8% in February. The headline March CPI (a fall of 0.3%) came in below expectations calling for no change. The 'core' CPI, excluding energy and food, fell 0.1%. In an attempt to draw some conclusions from the above seemingly mixed data – probably skewed by the same weather-related factors seen having affected the NFPs, and auto price mark-downs – we are encouraged that the University of Michigan's mid-April Consumer Sentiment index increased to 98.0, up from 96.9 in March, with the survey's 'current economic conditions' index hitting its highest level since 2000, showing a further increase in the number of households reporting an improvement in their finances. So consumer sentiment is strong, leading to the possibility of improving consumer expenditure in the current quarter. **Over long periods of time there has been good co-variation between this consumer sentiment index and the S&P500, as one would expect, especially given the importance of the consumer to the overall US economy, so the portents still look encouraging for the US equity market.**

In our January 'Outlook 2017' we said we expected global growth prospects to be revised upwards, thinking especially of the forecasts from the IMF, which we use as our consensus baseline. At that time the IMF was expecting growth of 3.4% in 2017, following 3.1% in 2016, with a further small improvement in 2018. It will be interesting to see this Wednesday how the IMF has revised its forecasts, especially by region. Any revisions are likely to be piecemeal, in the nature of these things, although it's the confirmation of the direction that counts. Forecasts for the US could be slightly lower, and those for the Eurozone (and even Japan) slightly higher. In a precursor speech made last week to the publication of that analysis, the IMF's Managing Director, Christine Lagarde, said global growth was improving, with the usual provisos regarding protectionist dangers to world trade, political risks, interest rates firming, still-wide income disparities, the need to prepare today's workers for technological change, and so on. Provided the improvement in relations between Presidents Trump and Xi can be sustained, the outlook for world trade may not now be so bad. **Our view is that the current global economic cycle is set to be unusually elongated. Ms Lagarde referred to '…a cyclical recovery', yet we believe it's going to be more structural in nature.**

"The French elections look too close to call"

Briefly regarding the run-up to the first round of the French elections, Marine Le Pen's lead in the polls has fallen in recent weeks. First-round support for her and Emmanuel Macron (Independent) slipped 0.5 points to 23.5% and 22.5% respectively, according to Bloomberg late last week. The first round of the election takes place on is on 23rd April. Jean-Luc Mélenchon (Far-left) has been gaining in the polls. While most commentators regard it as unlikely, a second round vote between Ms Le Pen and Mr Mélenchon would not be a good prospect for the markets. **The final vote remains even more difficult to call than a week ago.**

Saudi Arabia's latest bond issue - its first issue of dollar-denominated Islamic bonds - was helped by the recent firmness in oil prices, together with resulting easier domestic monetary conditions as demonstrated by a moderating 3-month SAIBOR (down to 1.7338%, from 2.38% in October). Saudi Arabia is running a budget deficit of the order of 7.6% of GDP this year, according to a consensus of estimates compiled by Bloomberg. The S&P Mena & Sukuk Total Return index stands at an all-time high of 117.74, and doesn't look extended. **The overall MENA bond market continues to develop positively, and yields on average of above 4% on diversified funds in this asset class are likely to continue to be very much of interest to both local – and increasingly, international – investors.**

"Our 'Outlook 2017' view of asset classes remains intact"

INVESTMENT SUMMARY: The Asset Allocation Committee meets later this week and will review many of the subjects covered in this report in detail. Until then, previously described investment policy remains in place. In recent weeks the Committee voted to reduce its overweight position in global equities on a tactical basis (specifically US, European, and Indian), in the hope that the equities correction envisaged in the Outlook 2017 would finally occur. It may well be that the geopolitical concerns that have affected markets during the last week or so will subside. Meanwhile, there has been some concern that the policies advocated by the Trump Administration are taking longer to become reality, and that the planned reflationary structural spending may have to be scaled-back. The measured flight to haven assets seen last week (stronger government bonds, a higher gold price, and firmer yen) appears to have resulted in the majority of commentators saying, for instance, that the break of the 2.30% yield level on the US 10-year Treasury may have ushered-in a new up-leg in global bonds. While we accept that the downside possibility in that yield may have to be adjusted downwards slightly, we disagree, and are more inclined to sell government bonds, rather than buy them. **We believe that the new 'cult of the equity' described in the Outlook 2017 remains in place, and that further – and synchronized – improvements in global economic growth favour structural overweight positions in equities, and that in time even more money will flow out of relatively poorly-yielding bonds, and into equities.**

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