From West to East

Weekly Investment View
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Claude-Henri Chavanon

Head of Products & Services
Wealth & Private Banking

Investors appear content with markets

The S&P 500 equity index edged a further 0.22% higher over the week (to 2,476.83), on the back of continued overall good second quarter earnings results, with the index a fraction below its record all-time close of a week ago. The eagerly-awaited US non-farm payrolls for July came in at 209,000 jobs added, beating expectations in the region of 183,000-190,000, and after an upwardly-revised gain of 231,000 for June (from 222,000 originally). Stated US unemployment fell to 4.3%, from 4.4% the previous month, and annual wage growth edged up to 2.5% (from 2.4%). These good numbers were instrumental in the US dollar being able to show a small increase of 0.26% over the week in terms of its index, to 93.542, after a recent closing low of 92.836. The euro had traded above $1.19, at which market commentators uniformly judged the currency pair to be very overbought. The euro ended the week at 1.1773, with investors now likely to view the 1.1500 level (or close) to represent well-defined support. The payrolls data led analysts to say that the Fed was still on course to formally announce a program of balance sheet shrinkage, increasingly expected at their September FOMC meeting, and also that the chance for a rate hike in December had firmed. The usual Bloomberg model for this now gives a 40.2% probability for this, up from 38% a week ago. Back in the equity markets, the Dow Jones Industrial index taking out the 22,000 handle to the upside - and after eight consecutive new highs - caused some 'roundaphobic' excitement, with the strength fueled by high-priced stocks such as Apple (after excellent results), the Dow being price rather than capitalization-weighted (like the S&P). By mid-week, European investors and commentators had begun to get more concerned about the strength of the euro taking the edge off export earnings. The Europe STOXX 600 index rose by 1.16% over the week, helped by Friday's correction in the euro, also helped by firmer financials. In bond markets, the Barclays Global Aggregate Bond index edged ahead by 0.17% over the week, to 479.1210, consistent with just under 3 basis points coming off the yield on US 10-year Treasuries (to 2.2620%), while noting that the yield on German 10-year Bunds fell by just over seven basis points (to 0.4680%). Lastly, in commodities, the Commodities Research Bureau index fell by 0.29% over the week, to 441.58, consistent with WTI crude being 0.26% lower. Copper was little changed in US markets, at $2.8850/lb for the active contract.

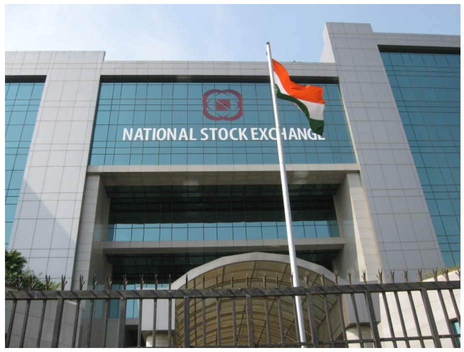
Markets are generally somewhere between being in a holding pattern, to continuing to gently trend upwards, with investors more concerned with a global economic background that looks increasingly sound – than with for instance the establishment a US Grand Jury to deepen investigations into any Russian involvement in last year's elections.

> ***"Investors are now prepared to view the euro more positively"***

The challenges facing the Eurozone may well be substantial, although at least (certainly given the advent of Mr Macron) there appears a willingness to attempt to make reforms. On the ground, popular support for the Eurozone has climbed to its highest since 2004, according to a new poll conducted by Eurobarometer, who found that 73% of Eurozone citizens supported membership of the single currency area, an increase of 3 percentage points from last year. French president, Emmanuel Macron, has mentioned the possibility of creating new Eurozone institutions, such as a finance ministry overseeing the whole regional bloc. Meanwhile, those who were worried about Brexit (both inside and outside the UK) are seeing more evidence of a gradualist approach, with transitions in place. Gains for the euro have been broad-based, with the Bloomberg Euro Index ahead by 8.30% for the year-to-date. There have been strong investor flows into Europe, and while strength in the euro can partly be said to have been a function of weakness in the dollar, it does look as though these have combined with steadily improving Eurozone fundamentals. As discussed in prior weeks, Eurozone economic growth has been improving, and over a period when expectations regarding US economic growth and stimulation have been reduced. **The Asset Allocation Committee meets later this week.**

"Low US inflation suits investors – if not the Fed"

The US non-farm payrolls increase of 209,000 was weighted towards hospitality and tourism, professional and business services, and health care. After declining earlier in the year, the unemployment rate (at 4.3%) has shown little movement in recent months, and the same is true of the labor force participation rate, which was unchanged at 62.9%. Employment gains have averaged 184,000 per month so far this year, close to the average monthly gain in 2016 (at 187,000), although over the last three months, job gains have averaged 195,000 per month. Other US economic statistics posted last week were mixed. The US ISM manufacturing PMI fell to 56.3 in July, from 57.8, almost in line with expectations for a fall to 56.4, which compared to Markit's US manufacturing PMI, which increased to 53.3 in July, vs. expectations of 53.2, up from 52.0 in June. Although one data series moved up, and one down, the overall story is a healthy one, not forgetting that manufacturing is estimated to account for about 12% of GDP, with services being much more important. Elsewhere, personal income in the US was flat in June, and up 1.4% year-on-year. Turning to the Personal Consumption Expenditure (PCE) price index for June - a measure of inflation - its headline price index was flat in June from the prior month, which was a second flat reading. Year-on-year the headline rate was +1.4%, now down four months in a row, and compared to last February's +2.2% reading. Looking at the 'core' PCE price index (i.e. ex-food and energy) - and the preferred measure of inflation by the Fed – this increased by 1.5% year-on-year, unchanged from May, and down from 1.9% last February. **These numbers are the ones that are frustrating for Janet Yellen and her colleagues (with their historic target of 2%) - less so for investors, as having inflation in place but at a low level is (a) good for bonds, which supports equities, and (b) allows for at least some pricing power on the part of business.**



"Indian markets have waited for this cut in interest rates, and in time will expect more"

The Reserve Bank of India (RBI) lowered its central policy interest rate to a six-and-a-half-year low of 6% in the middle of last week, from 6.25%. The Indian rupee strengthened, closing at 63.5825 to the US dollar at the end of the week, essentially as the markets underlined that the RBI is doing a good job with its monetary policy management, and because it was in any case widely expected that official rates would be reduced. The fact that economic growth is lower than expected, as mentioned by the RBI, is of little concern to domestic and international investors, whose focus is on the medium-to-long term, and who want to see less interest rate pressure on business. The decision by the RBI's Monetary Policy Committee was by a 4-to-2 margin. They cut the repo rate by 25 basis points, while otherwise keeping monetary policy in neutral. Inflation had fallen to a five-year low of 1.25% in the 12 months ending June. 'Core' inflation (excluding food and energy) was described by the RBI's Governor, Mr Urijit Patel, as having fallen significantly over the past three months. Indian GDP grew by 6.1% in the January to March quarter, the slowest rate since late 2014, following the 'demonetization' shock in November last year, while the introduction of the Goods and Services Tax last month has had a disruptive effect on businesses as they try to get to grips with it, and the RBI noted a weakening of industrial performance between April and June in consumer durables and capital goods. The RBI saw fit to refer to "continuing retrenchment of capital formation in the economy".

They said they would be watching inflation carefully, adding that prices could rise sharply from August. **The markets do appear to have their attention very much on the medium-to-long term.**

"The Asset Allocation Committee last week closed half of the euro/dollar hedge"

INVESTMENT SUMMARY: Last week the Asset Allocation Committee decided to reduce the currency hedge on euro-denominated assets by 50%, suggesting a willingness to accept that the hedge on that small proportion of assets in the portfolio models (i.e. a view that the euro would underperform the US dollar) was being disproven. While the Committee has been correct in its overall 'risk-on' stance – in terms of being overweight in global equities – the stance on the US dollar has been too positive. While the euro/dollar looks a bit extended to the upside - just as the dollar more generally may have some short-term bounce-back potential – the Committee is actively re-assessing the whole issue in terms of the 'big picture'. **Investors will never get every aspect of asset allocation right, just as portfolio managers cannot always pick winners in stocks or bonds. At least Eurozone (ex-UK) equities had been over-weighted in the first place, partly on the basis that the asset class was fundamentally cheap, and globally under-owned.**

For any inquiries related to this article, please contact Clint.Dove@nbad.com

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