From West to East

Weekly Investment View
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Finally a correction – a pause that should refresh

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The S&P500 ended up slightly on Friday, to close down 1.45% on a week affected by the escalating war of words between President Trump and North Korea. While it is never easy to predict exactly how global geopolitics (and these individual theatres of it) will play out, we and other commentators and investors finally appear to be getting something we had actually begun to miss – volatility. The newswires are full of how the VIX index (providing a market estimate of future volatility on the S&P500 index, based on a weighted average of representative options) rocketed from below 10 a week ago, to 15.51 as at Friday's close, i.e. back towards the historic range of 16-20. So Wall Street's 'fear index' came alive, with the usual rejoinder that this 'had to happen', and all of a sudden the bears are saying 'told you so' – as though they had been right about the market all along. Certainly, the markets need a bit more cut-and-thrust to be healthy, and to generate investment interest.
Irrespective of Bloomberg data to the effect that US equities now only represent 34% of global equity market value, global investors still think of the S&P500 first, just as for bonds they think of the yield on the US 10-year Treasury (and probably the yield on the German 10-year Bund second). The main 'safe havens' performed satisfactorily last week: gold, quality government bonds, and the Japanese yen - gold was up 2.42% over the week (to $1,289.31/oz), US Treasury bonds (as measured by the Bloomberg Barclays US Aggregate bond index) rose by 0.24%, European government bonds rose 0.66%, and the Japanese yen rose by 1.37% in dollar terms (to 109.19). **Accordingly the yield on the US 10-year Treasury fell by 7.3 basis points, to 2.1888%, quite close to a downside breakout which if confirmed would increase the probability of a further leg to what has been a multi-year global bull market in developed market bonds – so there are some very interesting levels to watch.**

"Continuing very low interest rates justifies higher P/Es for equities"

The US dollar last week fell by a further 0.50% on its index (DXY), to 93.069, adversely affected by weaker than expected US consumer prices for July. The US Consumer Price Index (CPI) rose by 0.1%, month-over-month, over-month, below market expectations for a 0.2% increase, and the fifth consecutive monthly miss, Goldman Sachs remind us. Meanwhile, the US Producer Price Index (PPI) for July had posted a decline, due to a combination of lower energy prices and flat food prices. The PPI fell by 0.1%, vs. market expectations according to Reuters for an increase of 0.1%. Mainly driven by this data, the usual Bloomberg analysis ('World Interest Rate Probability' – WIRP) at week-end was indicating a reduced 25.5% probability of a rate hike by the Fed this December, after almost zero for next month and November, the fundamental logic clearly being there is still little inflation/economic buoyancy in the US economy, whether measured by this data series, or the Fed's preferred 'core' PCE deflator. Apart from being driven by any further 'rush to quality', such data cannot be ignored by the FOMC as it sets rates, or as it calibrates the mooted reversal of its previous QE (so-called 'tapering' of its balance sheet). The Fed's inflation target remains 2%. A few weeks ago in the FAB Asset Allocation Committee one of the items for discussion was the extent to which further sustained (or even lower) levels of global interest rates really justifies a new, higher range of P/E ratios for equities, countering the oft-quoted "it's higher than 19 (or close to this) times earnings, therefore the P/E must be too high". **There are no hard-and-fast rules for this, but today's investor is gradually throwing away old-fashioned metrics, or levels of them.**

"Reducing Information Technology to neutral was precautionary"

For the month-to-date, the only S&P 500 sector to be up in absolute terms (by 0.9%) is utilities (followed by information technology, being up neglibly), and if sustained such a configuration would be a classic 'bearish rotation'. Rather than suggesting this is what is definitely happening, we remain open-minded. Although we still like the IT sector very much for the long-term, the small crack in the market last week – and after such a period of stability in the face of various (- mainly Trump-induced) negatives, IT should still be a 'high beta' sector, i.e. especially over the short-term amplifying directional market moves. The NASDAQ 100 Index (the more purely technology index, vs. the NASDAQ Composite) fell 1.16% last week, which must be considered minimal under the circumstances. Our readers know we have expected a moderate correction in equities (of 5-10%), and this was one reason why we finally took profits in technology a few weeks ago, and went 'neutral', from 'overweight'. At the same time we rotated to an overweight in health-care, this being a defensive sector, although one which should generate good 'alpha' (outperformance) over the medium-to-long term. Markets should not simply go up or down in a straight line, and had felt some normality was increasingly overdue. While we couldn't predict what the trigger would be, we have in a sense been frustrated that the markets (led by the S&P) have not corrected. Elsewhere in equities, the STOXX Europe 600 Index had a more difficult week than the US, closing down 2.72% (at 372.14), in all likelihood also reflecting the recent strength of the euro, which takes the edge off export revenues and foreign earnings upon translation. Turning to the Far East, Japan had a market holiday on Friday, with the TOPIX Index (which is better-constructed than the Nikkei 225) being down only 0.87% for the shortened trading week. The MSCI Asia Pacific (ex-Japan) equities index (covering China, Australia, South Korea, Hong Kong, etc.) closed 2.37% lower, more directly affected by the US-Korean war of words. **For all the reasons that we have been discussing in these reports in recent months (better economic growth than the average, overdone worries about Chinese debt, far more reasonable valuations – and relative to earnings growth rates, to name a few), the Committee is staying with its overweight in Asia Pacific (ex-Japan) equities.**

"China will make sure of no avoidable geo-political problems on its doorstep"

INVESTMENT SUMMARY: Of course we could be wrong, but it seems difficult to envisage armed conflict between the US and North Korea – at least we are not factoring that into our thinking, and have not increased our gold 'hedge' weighting above a normal 'neutral' level, or reduced equity weightings as a result of our Asset Allocation Committee conversations last week. China would certainly not tolerate any kind of escalation of hostilities (or the growing probability of these) on its doorstep. Nor would China be willing to lose face by President Kim being allowed to continue to misbehave after being reprimanded by them. Irrespective of how the North Korean situation gets resolved, we are mindful that North Korea (NK) and other rogue nations are being driven together. In the case of NK, UN sanctions now prevent the import of North Korean coal, iron ore, lead and fish. **Rogue nations can only barter (or cheat) up to a point; they all need hard currency.**

"We do detect improvement in crude oil markets – shale production isn't actually that important!"

In summary, in oil markets - and despite some obviously bearish developments (85% OPEC/NOPEC compliance with agreed production restraint, and still progressive US shale oil-based crude production, etc.) we believe that improvements on the demand side of the equation could be about to kick-in. This, along with production disruptions in Nigeria and elsewhere, together with what has been happening in Venezuela (and with Trump's threat of sanctions against the country) should bring the achievement of a better-balanced oil market closer. **In excess of $60 crude (basis WTI) is now a real possibility by the first quarter of 2018, once the Northern Hemisphere winter is underway.**

"Improved US earnings have been a saving-grace – pending tax reform"

Regarding President Trump, there are still a number of factors to consider, and which are frustrating investors. We note that Trump is increasing the intensity of the 'blame game' on Senate Republican Majority Leader, Mitch McConnell, given the Trump Administration's lack of progress in getting legislation through Congress. A sense of 'gridlock' has returned to Washington, but at least the US system has numerous checks and balances, pending the hoped-for passing of some measure of tax reform and infrastructure spending. The debt ceiling question is looming, although we expect this to be resolved before it causes a government shutdown. **Meanwhile, US corporate results have been exceeding expectations and the timing for this to be happening (and now boosted by a weaker dollar) couldn't be more fortunate, helping to underpin US equity valuations.**

"Investors should fully embrace diversification – by asset class, and geographically"

Lastly, this may be a basic point to be making, but we remain very enthusiastic about portfolio diversification, tailored to the particular requirements of individual client mandates. We continue to be aware that the average investor remains woefully under-diversified – by asset class, and geographically. On a selective basis we are fans of emerging markets, especially now that a measure of dollar weakness is helping them. Emerging markets have faster growth, and improving current account deficits .

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