From West to East

Weekly Investment View
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Claude-Henri Chavanon

Head of Products & Services
Wealth & Private Banking

The right people are staying

Investors had quite a lot to digest last week, especially as the North Korea situation had calmed down somewhat, with the chance of a quieter week. Unfortunately it wasn't to be. The sad events in Spain and Finland reminded us that terrorism is something that can and will wreak havoc, and that only ever more detailed intelligence can help. The prices of so-called 'haven' assets firmed with news of the Barcelona atrocities. The S&P500 index closed 0.65% lower over the week, actually not a bad result given the disbanding of two of the Trump Administration's US business councils following the defection of CEOs wanting to distance themselves and their companies from Trump's initial failure to condemn ultra-right wing elements in the violence in Virginia. Numerous members of his own Republican party also came out against the president, with US investors becoming worried mid-week that Gary Cohn and Steve Mnuchin (the 'Goldman Guys'), Chairman of the National Economic Council, and US Treasury Secretary respectively, would feel so incensed by Trump's remarks that they would resign. Mr Mnuchin was lobbied by 300 or so of his Yale alumni to do so. By the end of the week, however, it had not just become clear they intended to remain in their positions, but also that Steve Bannon, Trump's Chief Strategist had been ousted. Mr Bannon, although important in Trump's election victory (for instance as the originator of 'America First'), his brand of extreme economic nationalism was not sitting well with most of the president's other senior advisors. The banishing of such a divisive influence in the While House led to a 'Bannon Bounce' in US equities in Friday's trading session. General HR McMaster was hired as the new White House Chief of Staff a few weeks ago, and the ejection of Mr Bannon is no surprise, and follows some days of speculation about his future, fanned by the president himself. Sure enough, the end of the business councils on the face of it is a blow to Trump, but probably not a serious one. Provided his Administration ultimately delivers a measure of tax reform, infrastructure spending and a reduction in business red-tape, investors in US (and other) equities should benefit. We are fans of Mr Mnuchin and Mr Cohn, and provided they can continue to get on with the huge task of tax reform and the rest, investors could still see this bull market endure. **Of course there could some speed-bumps along the way (the possibility of a brief government shutdown pending agreement on the debt ceiling being the most obvious one) – and we might well see the moderate market correction we have been looking for – but there appears to be very little in S&P500 2018 earnings estimates penciled-in for tax reform and additions to infrastructure spending.**

"Our Asia Pacific (ex-Japan) thesis continues to play-out well"

The Europe STOXX 600 index closed up 0.55% over the week, held back by leisure stocks after the Spanish events. European equities had otherwise taken heart from an upward revision to second-quarter Eurozone GDP, to 2.2% year-on-year, from an initial estimate of 2.1%. With inflation in the Eurozone still low, we are not expecting the ECB's QE to be significantly slowed down yet. Readers will remember how the ECB President, Mario Draghi, seemed to brush-off concern about euro strength after their Council meeting last month – yet the minutes from that meeting published last week indeed highlighted worries about the strength of the single currency, and this caused some short-term euro weakness, capping a high of $1.1870. The euro closed at $117.61 last week. The Dollar index closed 0.39% firmer over the week (at 93.434), with the strength of US July retail sales (which increased by 0.6%, vs. expectations of 0.4%, with favourable revisions for prior months) seemingly overcoming an overall dovish interpretation of the FOMC Minutes for last month's meeting, analysis of which highlighted (a) members' continued frustration that inflation was still not responding to a tighter labour market, (b) that the appetite for balance sheet shrinkage is genuine, still to be announced 'soon', and (c) that because (b) is now seemingly discounted in markets, concern in the markets should be limited once the announcement is made. As at Friday's close the usual Bloomberg-based analysis of the probability of a December US rate hike stood at 35.7%, slightly up from 32.8% earlier in the week, so the markets are viewing the FOMC members as being fundamentally quite split between hawks and doves. In other equity markets, Japan's TOPIX closed almost unchanged over the week, despite some very good second quarter GDP numbers, showing annualized growth of 4%, with the 1% quarter-on-quarter actual easily beating the consensus forecast of 0.6%. **The MSCI Asia-Pacific (ex-Japan) index climbed 1.38% over the week, and China's CSI 300 index rose 2.11%, despite Chinese factory output coming in below expectations (at +6.3%, year-on-year).**

"The failure of the Tesla bond issue could be instructive – lighten-up on Technology"

More generally in developed equity markets, but more easily seen in the US than elsewhere, risk appetite has generally slipped, although not to the point where bond markets are registering concern (the yield on the US 10-year Treasury is holding, currently at 2.1905%). The VIX index closed the week at 14.26, within a range of just under 12, and 15.50, and one can tentatively say that a degree of volatility has returned, although it is not excessive. Long-term analysis of the VIX by Cycles Research Inc., suggests there is a rising seasonal trend beginning in mid-July, more-often-than-not lasting until about mid-October. Although slightly more anecdotal, seasoned market-watchers have noted that companies including Amazon and Tesla have very recently issued bonds in size ($16 billion by Amazon, and $1.80 billion for Tesla – the latter being increased by $300 million due to good demand); in the case of very free cashflow-generative Amazon, this looked very opportunistic and based on a very high P/E for the equity, while in the case of Tesla a coupon of 5.3% appeared rather too low for a company at that stage of its development. These are signposts that could be important, at least we think so. The Tesla 5.3% bond was almost immediately quoted below par, and now stands at $97.50. **Otherwise, the fall-out from the 'Amazon effect' for consumer discretionary sectors such as traditional retailers was exemplified by the fall of just over 27% in Footlocker's stock price last Friday, after poor results and forward guidance.**

"The bull and bear arguments in crude oil continue, but with less downside visible"

In commodities, the premium that Brent crude trades above West Texas Intermediate increased to $4.38/barrel, from $3.28 the previous week, with Brent 1.52% firmer over the week, compared to a fall of 0.63% for WTI. In the US, WTI weekly statistics showed crude inventories fell for a seventh successive week, but gasoline stockpiles were unchanged, vs. expectations for a drawdown. In other oil news, the IEA (International Energy Agency) followed OPEC in revising upwards its demand forecast for crude, and analysts noted that production had been interrupted at Libya's largest oilfield, Sharara, by about 100,000 barrels/day, apparently linked to issues related to worker safety. In a small news item we thought instructive, South Korea's customs service reported crude oil imports from Iran rose by more than a quarter in last month, although we would of course caution against taking just one month's data. Gold closed the week 0.40% lower, at $1,284.13, having failed to break through the $1,300/oz level (rather than simply being 'roundaphobic', that price level is technically significant, and a sustained break above it would almost certainly confirm a medium-term bull trend). **The London Metals Exchange Metals index (base metals) rose 1.88% over the week, with zinc being the standout.**

"We sense a willingness for Republicans and Democrats to work together"

INVESTMENT SUMMARY: Further to what has already been said about Washington politics, we would have been very concerned had Mnuchin and Cohn decided to leave. As far as we can see, they are key to the whole US economic equation, and even if due to political factors they only manage to get a portion of what they are working on signed into law, that should translate into reasonable equity market upside going into 2018, with knock-on benefits to other global markets. Certainly Donald Trump has some annoying and positively un-presidential tendencies, although it looks as though 'forces of reason' are beginning to encircle him. Democrats and Republicans have apparently begun to put their heads together to deal with those tendencies, and the log-jam, having realized for instance that, (a) although compromises will be necessary, Obamacare can be improved for the benefit of all, and (b) that a sufficiently high proportion of Congress appreciates that tax reform is needed for – again – compromise for something good to be worked out – and perhaps almost irrespective of President Trump. Members of Congress now have the mid-term elections increasingly in their sights, and they want to be able to show their voters what has been achieved in legislation so far. Meanwhile, Mr Mnuchin and Mr Cohn are said to have hundreds of experts working on economic policy, and they still intend to deliver. Separately, the round of White House firings has now gone quite deep, but with a growing hope that the so-called 'adults' remaining can now get on with the job – and especially given that 'President Bannon' has left. The Administration will have to do without the inputs from the Strategic & Policy Forum, and the Manufacturing Jobs Initiative, but input from business won't have stopped. Mr Carl Icahn, selected to advise the Administration on regulatory matters, has resigned, the quoted reason being to avoid conflicts of interest that he may have had. **Looking into next month, Congress will have to debate raising the debt ceiling, and a spending bill. According to the US Treasury, the debt ceiling must be increased by 29th September; support from the Democrats will be needed, and they will naturally see the opportunity to extract concessions from the Republicans.**

"The most bullish part of the FOMC minutes related to other advanced – and also emerging economies (ex-Latin America)"

In reviewing the minutes of last month's FOMC meeting, one of the most encouraging things to emerge for us was that Ms Yellen and her colleagues noted that economic growth continued to improve abroad, especially among the 'advanced foreign economies (AFEs), and that the pick-up in advanced-economy demand was contributing to relatively strong growth in China and 'emerging Asia' (Asia Pacific ex-Japan) in our terms, which includes China. The FOMC also noted that growth in Latin America remained relatively weak, partly reflecting tight monetary and fiscal policies. We are not very exposed to that continent in our Asset Allocation models. The FOMC also made the point that core inflation had stayed subdued in many AFEs (not just in the US), and that inflation was also low in most emerging market economies (EMEs). That last point is perhaps amongst the most interesting for us, in that it is, broadly speaking, a departure from history (in which emerging markets have typically endured asset allocation mechanism dislocations and volatile prices – horrible for investors), and will make emerging markets as a group even more attractive to global investors. Of course we will still have our favourites within them, while inflation will still be an intermittent feature of some of those economies. Meanwhile, real interest rates in the major markets are still negative, and hence very supportive of economic cycle prolongation. **The FAB Asset Allocation Committee meets late this week, and in the meantime investment policy remains unchanged.**

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

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