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First Abu Dhabi Bank

From West to East

Weekly Investment View

27th August, 2017

The Jackson Hole Edition

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The S&P500 index closed 0.72% firmer over the week, almost designed to frustrate a growing number of investors expecting US equities to continue to move lower. The Europe STOXX 600 index closed marginally lower, as did Japan's TOPIX. The MSCI Asia Pacific (ex-Japan) index, however, closed 1.60% higher, led by Chinese equities rising 1.91% in a technical breakout, by reference to the broad China CSI 300 index. Most markets were trading narrowly ahead of the speeches to be delivered by Ms Janet Yellen, Chair of the US Federal Reserve, and Mario Draghi, at the Jackson Hole symposium of central bankers and academics held towards the end of last week (which we discuss later in this report). Some commentators expected – at least in the case of Mario Draghi – guidance on current issues in global monetary policy, perhaps on the sidelines of the symposium, which had as its theme, 'Fostering a Dynamic Global Economy'. Such expectations turned out to be largely misplaced, however, as Ms Yellen concentrated on how the financial system should be kept healthy by suggesting not tampering too much with financial regulations put in place to deal with the financial crisis, while Mr Draghi also side-stepped most current issues. By way of omission, just as in his remarks after the last ECB council meeting, Draghi did not attempt to talk the euro down. This was taken as something of a red rag to recently converted bulls of the euro, who bid the single currency up to a close of $1.1924, up 1.39% over the week. The yen closed fractionally weaker against the dollar, following Bank of Japan remarks underlining that substantial monetary accommodation was likely to remain in place for some time. The dollar index closed 0.74% lower on its index over the week. As expected – and helped by the nebulous theme of Jackson Hole - Ms Yellen and Mr Draghi had obviously coordinated their lack of new information, to (a) keep markets relatively calm, and (b) to tip-toe towards a future phased shrinkage of the balance sheets of the Fed and the ECB (more so the Fed, the US being further along a growth path than the Eurozone). While Yellen in effect took aim at the Trump Administration, which intends to loosen financial regulation to boost growth, Draghi emphasized how he thought opposing protectionism and helping free trade was an important part of the answer to 'Sustaining Openness in a Dynamic Global Economy', and offsetting the effects of aging populations in various important economies. So they both took aim at the same target, sharing-out some of the areas between them. **Janet Yellen is not expected to be invited to serve another term as Chair of the Fed when her time is up early next year, while Mr Draghi and the bloc whose monetary policy he oversees is in many ways the antithesis of everything Donald Trump stands for.**

"But wait – US tax reform is still on the agenda of the Trump Administration…"

Early last week President Trump caused minor consternation in markets when he threatened to delay any US debt ceiling agreement, pending Congress agreeing to fund the building of the mooted 'Mexican Wall', but the mood improved towards the end of the week with commentators hearing there is to be a significant push on tax reform in the days to come. The head of the US National Economic Council, Gary Cohn, has apparently said a detailed proposal could be submitted to Congress before year-end. Separately, the US government must pass a budget by the end of September, and get Congressional agreement to increase its debt ceiling in October, to avoid a government technical default and shutdown. Meanwhile, there has been some market gossip suggesting the possibility that at least one of the senior debt rating agencies (Fitch) is considering downgrading US government sovereign debt from its exalted 'AAA' status. The US 10-year Treasury yield closed at 2.1659%, down just under 3 basis points over the week, and close to the bottom of its recent range. The more policy-sensitive 2-year Treasury yield firmed by two and ½ basis points, not breaking any important technical levels. **We don't believe there is anything (or certainly not much) in the consensus earnings estimate for 2018 S&P500 to account for tax reform or infrastructure spending – and the possibility that this may be too harsh a judgment could be one reason why even just a normal (i.e. 5-10%) correction in US stock prices has failed to occur so far this year. The S&P500 is currently trading at a moderate 16.8 x next years' earnings, which are estimated to be 11.2% higher than this year's.**

"The Jackson Hole presentations were more of a history lesson this year"

The Federal Reserve Bank of Kansas City hosts dozens of central bankers, policymakers, academics and economists from around the world at its annual economic policy symposium in Jackson Hole, Wyoming, which this year had the theme of 'Fostering a Dynamic Global Economy'. Janet Yellen, Chair of the Federal Reserve, said that, "A resilient financial system is critical to a dynamic global economy - the subject of this conference", having started her address by reminding those present that the global financial crisis of a decade ago had "… resulted in the most severe financial panic and largest contraction in economic activity in the United States since the Great Depression. Already, for some, memories of this experience may be fading - memories of just how costly the financial crisis was and of why certain steps were taken in response". She then went on to defend the reforms that, "…policy-makers in the US and around the world have made to improve financial regulation to limit both the probability and the adverse consequences of future financial crises". She mentioned that in the Jackson Hole discussion that took place in August 2007, "was fairly optimistic about the possible economic fallout from the stresses apparent in the financial system". So the Great Recession was indeed generally unexpected, and, "The economic recovery that followed, despite extraordinary policy actions, was painfully slow". Yellen went on to say, however, that "The evidence shows that reforms since the crisis have made the financial system substantially safer. Loss-absorbing capacity among the largest banks is significantly higher, with Tier 1 common equity capital more than doubling from early 2009 to now. The annual stress-testing exercises in recent years have led to improvements in the capital positions and risk-management processes among participating banks". She added, "Large banks have cut their reliance on short-term wholesale funding essentially in half and hold significantly more high-quality, liquid assets. Assets under management at prime institutional money market funds that proved susceptible to runs in the crisis have decreased substantially". "**Credit default swaps for the large banks also suggest that market participants assign a low probability to the distress of a large US banking firm".**

"Yellen said there may be benefits to simplifying aspects of prop trading by banks"

Ms Yellen added that, "…the Federal Reserve initiated a review of its stress tests…and this review suggested changes to reduce the burden on participating institutions, especially smaller institutions…". Also," …a broader set of changes to the new financial regulatory framework may deserve consideration. Such changes include adjustments that may simplify regulations applying to small and medium-sized banks and enhance resolution planning". She went on to say that, "…Some studies suggest that higher capital weighs on banks' lending, while others suggest that higher capital supports lending. Such conflicting results in academic research are not altogether surprising". She drew attention to a Federal Reserve assessment that "…pointed to sizable net benefits to economic growth from higher capital standards - and subsequent research supports this assessment". "Smaller firms rely disproportionately on lending from smaller banks, and the Federal Reserve has been taking steps and examining additional steps to reduce unnecessary complexity in regulations affecting smaller banks". She added, "Market liquidity for corporate bonds remains robust overall, and the healthy condition of the market is apparent in low bid-ask spreads and the large volume of corporate bond issuance in recent years. That said…Large dealers appear to devote less of their balance sheets to holding inventories of securities to facilitate trades and instead increasingly facilitate trades by directly matching buyers and sellers". Interestingly, Yellen mentioned, "There may be benefits to simplifying aspects of the Volcker rule, which limits proprietary trading by banking firms…". "**At the same time, the new regulatory framework overall has made dealers more resilient to shocks, and, in the past, distress at dealers following adverse shocks has been an important factor driving market illiquidity…".**

"Although the economic system is much safer than ten years ago, Chair Yellen still expects all-too-familiar risks to return in new ways, requiring policy responses"

So, Ms Yellen, asked, leading into her conclusion, "Where do we stand a decade after the financial crisis? In summary, she said, "Substantial progress has been made toward the Federal Reserve's economic objectives of maximum employment and price stability, in putting in place a regulatory and supervisory structure that is well designed to lower the risks to financial stability, and in actually achieving a stronger financial system. Our more resilient financial system is better prepared to absorb, rather than amplify, adverse shocks…". **'Nonetheless, there is more work to do", and, "Moreover, I expect that the evolution of the financial system in response to global economic forces, technology, and, yes, regulation will result sooner or later in the all-too-familiar risks of excessive optimism, leverage, and maturity transformation reemerging in new ways that require policy responses".**

"Draghi wants to see more international collaboration in regulation, and this won't sit well with Trump"

Mr Draghi's address was entitled, 'Sustaining openness in a dynamic global economy', and he began with the optimistic comment that, "The global recovery is firming up", continuing with, "In some countries like the US, this process has been visible for some years, in others like Europe and Japan, the consolidation of the recovery is at an earlier stage". He went on, saying, "At the centre of this debate is the question of how to raise potential output growth, which has slowed from around 2% in OECD countries in 2000 to around 1% today", and "Without stronger potential growth, the cyclical recovery we are now seeing globally will ultimately converge downwards to those slower growth rates. Slower growth will in turn make it harder to work through the debt and demographic challenges facing many advanced economies". Mr Draghi said that with population growth rate in advanced economies projected to slow, the world needs higher productivity, via keener competition, more research and development, and insolvency ring-fencing. As a key way of raising productivity, Draghi particularly advocated facilitating trade, and investment across borders, involving increased use and 'diffusion' of technology across those borders. What we thought he especially beat the drum about was achieving 'openness' in trade and investment, saying, "…this is a feat that countries cannot accomplish by themselves" - with the need to work through multilateral institutions, and benefitting from 'regulatory convergence', thereby increasing trust between countries - which then led him to recommend increased global financial sector regulation. He questioned what he saw as "the trend towards ever greater economic openness, which has defined the last three decades" possibly coming to an end, noting that, "Temporary trade barriers have indeed risen from covering around 1% of products in 2000 to more than 2.5% today". So his message was to beware the dangers of trade protectionism, aka currency manipulation, dumping, and any lack of reciprocal market access. Turning to the implications for the global economy, he said that going by their experience in Europe, "…the area where we need a special focus today is cross-border finance. Organizations that facilitate convergence in financial regulation and supervision, such as the Financial Stability Board and the Basel committees, are key in this context". Furthermore, Mr Draghi said, "…the stronger regulatory regime that we have now has enabled economies to endure a long period of low interest rates without any significant side-effects on financial stability, which has been crucial for stabilizing demand and inflation worldwide". Mr Draghi had no intention of saying anything whatsoever that would be taken out of context and come back to bite him before the ECB's 7th September policy meeting. **Bloomberg says that in subsequent Q&A, Mr Draghi made it clear that inflation moving towards the ECB's goal was still distant, that labour market factors are continuing to weigh on wage growth, all meaning that "a significant degree of monetary accommodation" is still warranted. The euro held onto its gains after he had finished speaking.**

"The Asset Allocation Committee is reconsidering the outlook for the dollar, on a pair-by-pair basis"

INVESTMENT SUMMARY: Firstly, the FAB Asset Allocation Committee met last week, with the overall conclusion that it was happy with current positioning, especially with the overweighting in recent months of Asia Pacific (ex-Japan) equities, which from the opening paragraph of this report readers will see has worked well (although with more left to go for in the medium-term). The Committee decided to look in more detail into the possibility that investment positives of

Japan could outweigh the negatives over the next year or so. Global asset allocators would be increasingly forced to buy non-US equities. Global bonds as a class were still in an uptrend, and supportive of the equity position. **As a postscript, the Committee is currently discussing whether to close the remaining portion of the euro hedge.**

"Draghi will still want to win the devaluation war, even if he's gone quiet for the time being"

Regarding the Jackson Hole discussion above, we cut through the transcripts to extract the parts of relevance, and to be honest it wasn't as much fun this year as last. It was interesting to note that Ms Yellen still expects a reversion to the mean of excessive risk-taking and leverage, surfacing in new forms – at 'some stage' i.e. not yet. Certainly, the US economic system is now in quite good shape – and in reality the Fed isn't totally against winding-back regulations – it just doesn't want this to go too far. Turning to Draghi, this was a justification of the ECB and the enveloping politics of the Eurozone, including the advice that international collaborative regulation should be expanded. **Finally, Mr Draghi probably knows the euro is fundamentally undervalued, and doesn't quite yet know how to conclusively win the currency devaluation competition.**

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