بنك أبوظبي الأول
FAB
First Abu Dhabi Bank

From West to East

Weekly Investment View
3rd December, 2017

Volatility to gradually build in risk asset prices – but that's healthy!

The news of the successful passage of a Republican US tax reform bill through the Senate came in the early hours of Saturday morning, Eastern Standard Time. Earlier, the S&P500 closed just five index points below Thursday's all-time closing high, at 2,642.22, up 1.53% over the week - although with more intra-day volatility than had been seen for some months - prompted by the news that Michael Flynn, President Trump's former national security advisor, had pleaded guilty about lying to the FBI. A few weeks ago we suggested that equity markets might gradually be returning to some kind of normality (i.e. not simply a bullish one-way trend), and the fact that the tech-heavy NASDAQ Composite closed 0.60% lower over the week hinted at more of a propensity on the part of investors to take profits. Any return to a bit more volatility in equities would surely be a healthy development, as investors wouldn't feel they were so often having to pay up when putting money into the market. In other possibly significant news, the outlook for a more orderly Brexit than seemed likely of late took a turn for the better, with speculation that terms of the financial divorce settlement were close to being reached. Cable, which almost tested the $1.30 level a few weeks ago, rallied to a close of $1.3477, up 1.05% on the week. European stocks closed lower, with the STOXX Europe 600 index down 0.69% on the week. The recent interest in Japanese equities was maintained, with the TOPIX index up by 0.90%. Elsewhere in Asia-Pacific, by the end of the week the correction in Chinese equities had moderated, with the CSI 300 closing down 2.58% over the period, 5.43% below the recent closing high. The Chinese authorities are continuing with their credit squeeze, involving clamping down on the sales of risky investment products, and the economic tone in China has been more downbeat in the last few months – although this has not dampened our medium-term enthusiasm for Asia-Pacific (ex-Japan) equities. **Similarly, the MSCI Asia-Pacific (ex-Japan) index (which includes China) has given back some of its gains, which we regard as a healthy development as that index stands 29.51% ahead for the year-to-date.**

"We always believed US tax reform would happen"

In global bond markets, the Bloomberg Barclays Global-Aggregate index (unhedged) edged down by 0.20% over the week, to 483.1435, broadly consistent with the yield on the US 10-year Treasury bond rising by just under two basis points over the week. The yield on the US 2-year Treasury rose further, by 2.8 basis points, to 1.7720%, having traded slightly above the 1.80% level earlier intra-day. The Flynn news caused a short-term flight to quality/havens, so rates came off by 3-5 basis points from their highs. In foreign exchange markets, in recent weeks the dollar had been driven more by politics than economics, with anticipated Trump/Republican negatives – mainly worries about whether US tax reform could be passed in the immediate weeks ahead, or whether it would all be delayed into next year. Such worries have more than countered economic statistics coming in better than expectations in the US; the Citi US Economic Surprises index closed last week at a very positive reading of 60.10, up from -78.60 since June this year. It was known that the tax reform vote of last week in the Senate was going to be close - would the 'hold-outs' come on-side in time? Over the week, the dollar closed very slightly firmer on its index (at 92.885), and we would expect more volatility with the greenback responding to what looks like a growing tide of news flow towards and through the year-end - both good (economically) and bad (potentially politically, as news outlets get even further fired-up regarding the Robert Mueller-led investigation regarding possible collusion with the Russians during last year's US election campaign. In commodities, the agreement by OPEC and its partners (led by Russia) to keep already agreed production restraint in place until the end of 2018 helped to keep Brent crude prices firm, with WTI benefitting less due to an increase in the US rig count. Brent closed fractionally lower over the week, at $63.73/barrel, with its positive spread vs. WTI increasing to $5.37, from $4.91 at the end of the previous week. Separately, the International Energy Agency reckons the level of compliance with agreed production levels stands at 86%, and if that's correct it should probably be considered quite a good result. **Lastly, gold closed 0.60% (or just under $8/oz) lower on the week, at $1,280.62, having in the meantime traded up to $1,300, which still represents significant technical resistance.**

"US growth is looking good anyway – before tax reform"

Turning to US economic data, third quarter GDP growth was revised upwards by three tenths of a percentage point, to 3.3%, the fastest rate since 2014; looking at what drove this, business fixed investment was

revised upwards, as well as the business inventory building, while personal consumption was revised downwards (consistent with recently flat retail sales). Elsewhere, the ISM manufacturing PMI (purchasing managers index) came in at 58.2 (down from 58.7 the previous month), slightly shy of estimates - although clearly stands at a high level historically. Any figure above about 57 is very good. In the Eurozone, Eurostat inflation came in at 1.5% year-on-year, slightly lower than expectations, once again frustrating ECB officials targeting a 2% level. In Japan, core inflation (CPI nationwide, ex-fresh food - their definition of 'core') year-on-year, came in at 0.8% for October, up from 0.7% in the previous month. This compares to an official target also at 2%. **The labour market in Japan is very tight, and corporations are having difficulty filling vacancies, using extra benefits to lure (and retain) workers; producer price inflation has risen to above 3% year-on-year, but corporations have lacked the pricing power to pass this onto customers.**

"The Bullish Consensus is nowhere near a 'Sell' yet"

INVESTMENT SUMMARY:

The passage of the Republican tax reform bill through the Senate is very significant, and could lead to further firmness in US equities next week. This was a tough job to get done, but by two votes they managed it. Further details will follow as this version gets reconciled with the House version, along we really don't expect any difficulty in them completing this now. Our view on whether this important legislation would be successfully carried has been positive all along. The BBC showed how the final terms of agreement were reached with hand-written notes in the margins - it doesn't matter if it was scruffy - it's done. As we have said before, we don't think any of this was in analysts' forecasts. EPS Estimates may rise by up to 5% for 2019, as an initial guide, although such numbers are subject to fine-tuning. The effective US tax rate during the last year or so was already done at 26% or so, vs. the officially-stated 35% corporate tax rate. Changes to personal tax thresholds will have to be gone through carefully.

Trump himself is far from out-of-the-woods on the Russia issues. Despite Trump's assertion that Flynn had done nothing illegal in the run-up to the inauguration, he said Flynn had to be fired because he lied to the FBI and to the Vice-President (so Trump made it clear he knew about the lying to the FBI) – and there is still the issue that Trump supposedly pressured FBI chief Comey to let Flynn off the hook.

Global investors have begun to live with Trump's constant Twitter feed, but from this point should be more interested in hard economic news, bearing in mind that the US has checks and balances in place, even in the unlikely occurrence of the impeachment of presidents.

On Brexit, Theresa May and her team have apparently increased their offer for the financial divorce, which if confirmed should allow talks to progress to a trade deal. Irish elements may still be problematic. The exact financial amount depends on the technical terms and definitions. All in all, the discussions have taken a turn for the best. Sterling is not taking much on trust, however.

So will it be a case of 'Buy the rumour, sell the news'? Like other market participants we will be carefully following events and forecasts (of growth, earnings and inflation expectations). The locking-in of equity gains, and by professionals to secure their bonuses, has already been happening, with selling so far well-absorbed as players look into 2018. Meanwhile, a Reuters poll last Thursday noted the relative bullishness of equity investors, over two-thirds of whom see gains continuing throughout next year. A so-called 'Bullish Consensus' approaching 80% would concern us – but we don't believe we are yet anywhere near that point.

News that Greece and its Eurozone creditors reached a preliminary deal this weekend on reforms that Athens will put in place under its bailout program is a move that could pave the way for Greece to leave the aid plan in August next year – in sentiment terms this would be good for all concerned.

The FAB Asset Allocation Committee meets this week, and will fully discuss the above points, and many others as we head towards the completion of 'Outlook 2018'. Until then, investment policy remains unchanged – most importantly, overweight in equities, especially in the US. It will be interesting to see whether sentiment (and raised estimates) will offset what we might call the 'Flynn Factor'.

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

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