NBAD

From West to East

Weekly Investment View

5th February, 2017

Weight of money overcomes background noise

Investors watching Trump Administration dealings throughout last week – with so-called 'tough' phone calls between the President and various world leaders, the responses to the selective travel ban he imposed the previous week, and the imposition of new sanctions against Iran following its latest missile test – might have expected the S&P500 index to close the week with some hesitancy. However, the index closed up 0.12% over the week, at 2,297.42 (and up 2.63% for the year-to-date), just failing by a point or so to close at a new all-time high. The MSCI World index closed ahead by the same amount. The US Federal Reserve held rates on Wednesday, as expected. The yield on the US 10-year Treasury fell by two basis points over the week, to 2.4648%, further reflecting a degree of calmness despite all the background noise. The US dollar lost a further 0.66% on its index, after a recovery bounce to 99.868 on Friday, affected by Trump Administration accusations against the ECB and BOJ of currency manipulation, as well as commentators interpreting the latest US Non-Farm Payrolls data as possibly taking the immediate heat out of the Fed's quest to normalize rates. So investors were reminded that the weight of money rules, with Financials, Healthcare and Technology leading the way on Wall Street, the former being driven by the prospect that financial sector regulation (in particular) will be considerably slackened. We, amongst others, have been expecting the Dodd-Frank measures, brought in to enforce greater US banking prudence in the wake of the 2008-09 economic debacle, to be unwound as the Trump Administration wants to facilitate improved bank lending. Elsewhere, oil prices firmed on the back of the Iranian developments, and despite bearish US inventory data. Historically, Februarys following US general elections have seen weakness in US equities. **We have been expecting a 4 -5% correction in US stocks, which we would see as a buying opportunity to add to what is an already overweight position, one that is still tilted towards Banks and Technology – although if by the end of February the correction has not occurred, that would be quite bullish.**

"The Fed is still very data-dependent – so no hike just yet"

The US Non-Farm Payrolls for January, the first full month of the Trump era, came in at 227,000 additions, compared to expectations of about 175,000, and vs. a revised 157,000 in December. An estimate of 175,000 for this metric is usually what economists say when they have no firm view. Although the result was on the face of it a good number, and confirmed the upbeat private sector data released two days earlier, **commentators were more concerned that annual wage growth slowed, to 2.5% from a revised 2.8% in December, and that unemployment ticked up slightly, to 4.8%, rather than remaining unchanged.**

Although it is perhaps a bit early in the year to be thinking like this, cynical observers suggested this could all result in fewer than the three rate hikes indicated by the Fed last December, after a few years during which the Fed said they expected to normalize but then failed to (including a quarter a few years ago when annualized GDP growth exceeded 5%). According to the usual Bloomberg analysis, markets currently carry a 30.0% probability of a hike in March, and 48.6% in May. **Having left rates unchanged, the Fed wants more evidence in terms of data points, as well as greater certainty regarding the economic policies of the new Administration.**

There was no Fed press conference (with its usual helpful Q&A session) last week. Looking through the statement released,

Claude-Henri Chavanon

Managing Director
Head of Global Asset Management

we think the main takeaways over-and-above their usual comments, were as follows: (1) Household spending has continued to rise moderately and business fixed investment has remained soft, although it was noted that measures of consumer and business sentiment have improved of late; (2) Inflation is still below their 2% longer-run objective, and most survey-based measures of longer-term inflation expectations are little changed, on balance; (3) With gradual adjustments in monetary policy, economic activity will expand at a moderate pace, labour market conditions will strengthen somewhat further, and inflation will rise to 2% over the medium term; (4) They repeated that "The Committee expects that economic conditions will evolve in a manner that will warrant only gradual increases in the federal funds rate…". Inflation on the measure they use, the Commerce Department's PCE Deflator, may well be 1.7%, although (a) this could soon change – consider what happened to Germany's inflation numbers published last week, and (b) the CPI produced by the US Labor Department is already above the all-important 2% level, at 2.2%. Other points to make/reiterate are that we do expect corporate capital expenditures in the US to recover, and also that the inflation surprises indices we monitor for the US and other major economies appear to be picking up. **The markets-based (as opposed to 'survey-based') five-year forward breakeven inflation rate index we follow has been a good lead indicator for the Fed's own published model, and has moved through 2%, currently at 2.05%.**

"An overweight India strategy in equities continues to look sensible"

Last week Indian Finance Minister, Arun Jaitley, delivered his proposed budget for the 2017/18 fiscal year, designed to help bring about economic recovery after the (quite severe) shock of demonetization, and to especially help the poor, who were particularly hard hit by it. The painful short-term effects of recent government policy would abate soon was the message. The projected fiscal deficit target in 2017/18 has been raised to 3.2% of GDP, from 3%, reflecting increased government spending (in rural areas, and in infrastructure as previously detailed), and with reductions in taxes to get the middle classes and SME owners back on side, prior to five important state elections coming up. Mr Modi's government had to act to negate the short-term pain of demonetization. The basic rate of income tax has been halved. The above measures require the sale of just under $11 billion of state assets. At the same time, Mr Jaitley underscored the risks should oil prices rise, trade protectionism take hold, and/or hikes in US rates cause economic pressures, none of which should come as any surprise. In terms of earnings on the Sensex index, the market is assuming 10.2% growth for the current year, with 19.0% penciled-in for fiscal 2017/18, producing a P/E of 16.1x for that year. In reality, prescient investors have allowed for a dent in earnings growth in the light of demonetization, and are much more interested in operationally leveraged earnings potential 2-5 years ahead (which is our stance). Indian equities should be supported by continued fund flows, also given that equity managers are thought to be holding about 7-8% in cash. At the same time there has been a rotation out of bonds after yields moved to the downside, with the India government 10-year yield currently at 6.41%. The Sensex and the rupee have responded favourably to the budget, which itself appears to have addressed the right issues, and especially given the pain that demonetization has wrought. **Indian equities are up by 6.0% for the year-to-date, and continue to be our principal overweight position in global emerging equities.**

MENA markets had a very interesting week. Kuwait continued to be the standout market for stocks, with its world-beating run so far this year continuing last week. This has provided a solid backdrop to Kuwait's highly anticipated maiden sovereign bond issue, with a number of banks already said to have been selected for the sale. S&P last Friday affirmed Kuwait's rating at AA/A-1+, with a stable outlook ahead of any bond sale. In Saudi Arabia, strong data has continued to boost market valuations. Growth in Saudi Arabia's non-oil private sector has recently accelerated at the fastest pace since August, 2015. The Saudi PMI showed a healthy uptick after the government resumed paying overdue debts to the private sector in an ongoing recovery in receivables that continues in the Kingdom post- their large government debt issuance last year. **In the UAE, 5-year Dubai credit default swaps protection closed at their lowest levels since the summer of 2014, at 137.0, showing continued confidence in the emirate, helped by its successful economic diversification.**

"MENA bonds continue to grow in stature as a market"

MENA corporate bond issuance has continued at a healthy pace. Equate Petrochemical Company is starting the week with a global roadshow. Rated Baa2 by Moody's, and with a stable outlook, Equate is a joint venture between Kuwait's Petrochemical Industries Company and Dow Chemical of the US. A senior unsecured tranche with a tenor of 7 years is expected. Elsewhere, Dubai Islamic Bank, the largest Islamic lender in the UAE, is expected to come with a 5-year senior unsecured sukuk as part of its ongoing EMTN programme, and is rated Baa1. Lastly, last Thursday Fitch downgraded 18 Turkish banks following the previous week's downgrade of Turkey sovereign bonds. Turkey's long term foreign currency issuer default rating (FC IDR) last time round had been moved from BBB- to BB+. The downgrade of the Turkish banks this time round was done to reflect this, and was largely expected by the market. 5-year Turkey sovereign CDS default swaps continued to impress with protection now down to 250 basis points, from the previous week's 272 basis points, following the sovereign bond downgrade. **Overall in MENA bonds it was a similar story of spread compression vs. US treasuries that dominated the price action for the week.**

INVESTMENT SUMMARY: Our investment strategy remains unchanged, i.e. we favour equities over bonds, and within equities we prefer developed vs. emerging (with overweights in the US and Europe). In EM equities we are overweight in India. In bonds, we favour High Yield over Investment Grade. In currencies, we remain bullish of the US dollar in 2017, especially from current levels. We still expect three rate hikes in the US during the current year. **The NBAD Asset Allocation Committee meets later this week.**

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