From West to East

Weekly Investment View

12th February, 2017

The equity bears are being proven wrong

Last Friday, the bellweather S&P500 index closed at a record 2,316.10, up 0.8% over the week, spurred by Donald Trump's promise of a "phenomenal" imminent announcement on tax policy, and following recent weeks during which commentators had been agitating for some hard news. The NASDAQ Composite and the Dow Industrials followed suit, providing confirmation that equity market bears may have to re-think their strategies. For the month-to-date, US equity leadership has come from technology, financials and industrials; for the year-to-date, technology, consumer discretionary and materials have led the way. Similarly the US dollar index recovered by 0.9%, after a series of lower weekly closes that had caused investors to begin to think that further weakness was possible. European equities followed US stocks higher, despite weakness in Italian bank stocks, while Japanese stocks did even better (+2.4%) helped by a weaker yen. The benchmark yield on the US 10-year Treasury bond closed almost 6 basis points lower (at 2.41%) after a good US government debt auction during the week, with the conclusion that critical yield levels to the upside had not been broken. Gold closed off its best levels (at $1,233.62), although was still up just over 1%, reflecting the upward blip seen in known gold ETF holdings over the week. **Apart from new highs in US equities, perhaps the most encouraging aspect of last week is the steadily improving technical condition in European equities, despite growing angst as the various elections are now increasingly in focus.**

'Making use of the Goldman Guys'

For Trump and his Administration, the question of the legality of his selective immigration controls will have been annoying, but in the space of a few short weeks they have moved on to more positive things – such as tax cuts – in the run-up to the important Presidential address due on the 28th February. We believe investors are becoming more aware of which Trump policies and bluster constitute 'background noise', and which do not. Yes, there are ways in which the President has been inconsistent, and in truth he and his team are to a real extent learning on the job. While this might be seen as rather a dangerous thing to behold, we find it rather less so than many, and remain confident that when the history books are written he will be judged to have done a good job. Certainly it's early days in the current presidency, and a huge amount of hard work must be underway. Trump's supporters seem thrilled with the fact that he has been faithfully rolling out what was described on the can, while the markets – apart from those very early wobbles – are embracing the agenda. So having been critical of the likes of Goldman Sachs during the election campaign, he is now doing his level best to ensure that such brainpower is fully utilized for the benefit of America. Let's not forget that the 'Goldman Guys' (as they are increasingly called) understand how to make money – and in all likelihood they can work out novel ways to help plug fiscal deficits. **Of course it's not as simple as this, but provided most of the 'background noise' stays that way, the markets should remain happy.**

In foreign policy, Trump's often unsubtle and 'off-the-cuff' approach has caused disquiet, almost as though he is practicing the chaos theory that some believe he genuinely relies upon to gather information, and to befuddle the parties with whom he is negotiating. Over the weekend we have learned that the Trump Administration will apparently not act against the 'One China' policy, following a series of pronouncements and actions that must have bothered even the Chinese. **At the end of the day, investors seem happy to hold the S&P500 (to name just one index), which is trading on a**

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2018 P/E ratio of 15.9x, according to Bloomberg, likely in the belief that estimate revisions will be positive. We continue to favour Financials and Technology.

"Imbalances remain in the Eurozone"

We really like to see markets that are climbing proverbial 'Walls of Worry'. It was suggested in the first paragraph that European equities are looking better on a technical basis - yet should investors not be thinking about the politics? – or the return of Grexit concerns? Additionally, the divide between the German Finance Ministry and the ECB appears to be re-opening. Firstly, the politics: Geert Wilders may well win in the Netherlands in March, although if he does win he would have to deal with a coalition. The French presidential candidate, Marine Le Pen has said she would take France out of the euro if elected, and bring a 'New Franc'. Opinion poll observers suggest that Mr Fillon or Mr Macron (despite their own problems) would comfortably beat her in the second round of the election (in what would then be a two-horse race) –

however, we know about the dangers of following polls, don't we? In Italy, we know that the Five Star Movement is quite close to the leading Democrat Party in polls, and that they want a referendum on euro membership. Also, now in Germany, Mr Schulz has overtaken Mrs Merkel in the opinion polls, having gained about 10% in recent weeks. The Federal elections in Germany have to take place before the 23rd October, and the electorate are increasingly unhappy with Merkel, especially regarding immigration issues. Turning to Greece, the IMF is once again saying that the Greeks need substantial debt relief and less tough fiscal targets as conditions for further bailout funds, yet the ECB remain very much opposed to these – and large debt repayments are due from Greece to the ECB this summer. In other news, German Finance Minister Wolfgang Schäuble has said the euro is too low, and that monetary policy is "too loose" for Germany, according to the FT. As we have noted before, the German Finance Ministry has never really believed in the ECB's QE policies. Set against all this - at least in the short-term - is for instance the news that the eurozone's preliminary economic climate index rose to 17.2 'balance points' in 1Q17 (vs. 8.2 balance points in 4Q16), suggesting that the economic recovery is gathering momentum, and that the current conditions indicator climbed to 8.0 in 1Q17 (vs. 2.3 in 4Q16). **Meanwhile, Mario Draghi is now not expected to taper the ECB's QE until there is even more evidence that inflation has returned.**

Given the apparent list of all the possible negative news that could come out of the eurozone, what should investors expect? While we believe the structural issues bedeviling the eurozone are substantial, at least for the time being we would expect the following to happen in the event of political and/or market negatives: the euro would immediately take the strain (towards and possibly through parity against the dollar), and just as occurred in the UK (with sterling weakness being a shot in the arm to equities, which then subsequently went to all-time highs), European stocks would see major upside, despite political and/or other uncertainties. The Euro Stoxx 600 index is currently trading on a 2018 P/E ratio of 13.8x, down from 14.6x for the current year, and based on earnings growth of 5.9% in 2018. **We believe the 2018 growth estimate will be subject to upwards revision, and as long as non-euro based investors have fully hedged the currency, all will be well for this tactical overweight in European equities.**

"Oil wobbled, then stabilized on better statistics"

The crude oil price closed almost unchanged over the week, at $53.86 for WTI, yet there were a few swings in sentiment along the way. Early in the week concerns about rising production from US shale began to tip oil prices lower, as well as the possibility that output from those not included in the November OPEC (and 'NOPEC') accord were offsetting the effectiveness of the deal. Then the American Petroleum Institute reported an inventory build of 14.2 million barrels in US crude supplies for the previous week (vs. a forecast of +2.38 million) as domestic production increased and imports rose. Then came the good news that according to the Energy Information Administration, OPEC crude production was believed to have fallen by 1 million barrels/day, to 32.06 million barrels/day in January, leading to record initial compliance of 90% with the output agreement. Saudi Arabia was believed to have reduced production by more than originally agreed. In addition, total world oil demand was revised up for the quarter just passed, with investors being aware that the current estimated growth in demand could rise from the 1.4 million barrels/day assumed for the current year. **The oil price remains solidly in our forecast range of $45-60 for WTI; we have been saying for some months that the demand growth side of the oil equation has been underestimated, and should eventually come to rescue of the oil price, producing a better outlook for 2018.**

INVESTMENT SUMMARY: The NBAD GAM Asset Allocation Committee met late last week, and made no changes to investment policy, following various changes made at the previous few meetings. The recommended asset allocation is as follows: Underweight cash; marginal underweight in Fixed Income, via government bonds; reasonably overweight in Global Equities, via overweight positions in North America, Europe, India, and MENA; underweight in Alternatives, via commodities and hedge funds, although remaining neutral in gold as a hedge. Lastly, there was a hint in a Bloomberg story that Christine Lagarde, managing director of the IMF, and speaking in Dubai today, was possibly going to announce an upward revision to the IMF's global economic growth forecasts. This was a stated expectation in our NBAD Global Investment Outlook published last month – rather than growth estimates starting low and then being revised downwards as in recent years. **We remain optimistic for many risk asset prices for 2018.**

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