NBAD

From West to East
Weekly Investment View
19th February, 2017

Increased equity weightings look sustainable

As Friday approached it was looking as though the recent run of higher weekly S&P500 closes might finally end, at least for a while, and then came news that Unilever, one of the world's largest consumer staples companies, had turned down a $143 billion approach from Kraft Heinz, another huge entity that is managed along totally different lines. With help from this shot in the arm (and strength in telecommunications services) the S&P500 closed the week at a further new record after all, at 2,351.16, up 1.51% over the week, and 5.02% ahead for the year-to-date. The MSCI World index (currently estimated to be 58.7% in US stocks) also closed at a new all-time high, up 1.20% over the week, and 4.87% ahead for the year-to-date.

'The equity uptrend looks especially strong'

In the US it turned out to be a rather surprising week, in various ways. Janet Yellen's testament to the Senate Banking Committee was deemed to have been more hawkish than of late. Turning to President Trump, he asked for the resignation of his National Security Advisor, only to be turned down by his chosen replacement for that position (supposedly because the latter had wanted to bring in his own team). We should also mention a Trump press conference at the While House which simply had to be seen to be believed, in which the President once again heavily laid into sections of the world's press, with almost stand-up fights with CNN and the BBC. Those of us who have been bullish and content to look through and past a certain amount of Trump-generated background noise while awaiting details of tax changes et al began to lose some patience – until the weight of money in the markets reasserted its power. There has in reality been a growing dichotomy between many technical analysts on the one hand who view the markets (and the S&P and NASDAQ Composite and 100 indices in particular) as increasingly overbought, vs. those who draw attention to the fact that these equity indices, while moving ahead along their upper technical boundaries, have actually not moved beyond them – tantamount to asking whether it makes sense to bet against such an apparently powerful trend. **Although staying long of equities during recent weeks has made sense, some general profit-taking will surely surface at some stage, although we would expect this to be short-lived.**

The US dollar had a steady week, with its index closing 0.15% firmer, at 100.95. A degree of yen strength was offset by renewed worries for the euro as markets speculated on the outcome to Dutch, French, and also Italian elections, while it became increasingly clear that the Greek bail-out standoff was unlikely to be resolved in the short-term, and so could become more of a 'live' issue in those elections. The Janet Yellen headline quote from last week to the effect that it would be unwise for the Federal Reserve to wait too long to raise rates provided a more solid undertone for the dollar, with the latest Bloomberg futures-derived analysis registering a 34.0% probability of a 25 basis point hike for March (up from 30% earlier in the week), 55.9% for May (up from 48% earlier), and 74.8% for June. The US Treasury 2-year yield remained little changed over the week, at 1.1882%, with the US 10-year yield similarly little changed, at 2.4073%, following a rally to the 2.50% level after Yellen. The bottom-line here is that the latter bellweather yield remains substantially under control within its recent range, and the same remains true of the German 10-year, at 0.302%. Lastly, however, one of our sources reminded us that since the financial crisis, US (and other) banks have been adding to Treasuries because they qualify as 'safe' assets that help in meeting required regulatory capital ratios. US commercial banks are now thought to hold $2.4 trillion in government debt and related securities, more than twice the amount of nine or so years ago, according to the St. Louis Federal Reserve. **More lax regulation would result in less demanding capital requirements, and they could accordingly reduce those Treasury positions.**

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'The latest batch of US economic data was good'

In our latest 'Yellen Watch' section, please find below our key takeaways from her testimony last week, in addition to the widely-quoted, "…waiting too long to remove (monetary) accommodation would be unwise, potentially requiring the FOMC to eventually raise rates rapidly, which could risk disrupting financial markets and pushing the economy into recession". She said, "Ongoing gains in the labor market have been accompanied by a further moderate expansion in economic activity. US GDP real gross domestic product is estimated to have risen 1.9% last year, the same as in 2015". She observed that, (1) "…business sentiment has noticeably improved in the past few months"; (2) "My colleagues on the FOMC and I expect the economy to continue to expand at a moderate pace, with the job market strengthening somewhat further and inflation gradually rising to 2%": (3) "…most survey measures of longer-term inflation expectations have changed little, on balance, in recent months". When it comes to the last point, although the comment specifically mentions 'survey measures', we - and others in the markets - are increasingly aware of a pickup in inflation expectations, to which we'll return below. In other US economic news, retail sales rose by 0.4% in January, more than expectations for growth of 0.1%, and the December figure was revised upwards, to 1.0%, from 0.6%. The headline US consumer price index rose a seasonally-adjusted 0.6% last month (or 2.5% year-on-year), the largest amount for four years, and vs. expectations for a rise of 0.3%, partly due to higher gasoline prices. The 'core' CPI (excluding food and energy), however, rose 0.3% month-on-month (making 2.3%, year-on-year), counter to expectations for a small fall. The US producer price index rose 0.6% in January (vs. a 0.2% rise in December, and expectations for a rise of 0.3%, largely due to higher energy prices). Lastly, industrial production fell by 0.3% last month, largely due to a 5.7% fall in utilities output and vs. expectations for no change. **So the latest batch of US economic data was broadly constructive.**

Turning to the outlook for growth in the eurozone, the European Commission said last week that uncertainty about US policies, Brexit and elections in Germany and France could impact growth in the bloc this year. GDP growth in the 19 countries using the euro would likely slow slightly to 1.6% this year, from 1.7% in 2016, and then improve to 1.8% in 2018. They expect German GDP growth to be 1.6% this year, vs. 1.9% last year, and French growth to accelerate from 1.2% to 1.4% this year. Growth should remain in the 0.9% range in Italy this year. The Commission expects consumer prices in the bloc to accelerate to 1.7% this year, from only 0.2% last year. The latest wholesale prices statistics from Destatis for Germany, showed these increased the most in five years last month, increasing by 4.0% year-on-year, up from 2.8% in December. German consumer price inflation rose in January at an annual rate of 1.9%. Led by Germany, growth should continue to be at the low end although just about acceptable under the political circumstances, and helped by our expectations for a euro that should trade below parity against the US dollar later this year. **As detailed in last week's report, we continue to favour European equities.**

'China could now be exporting inflation, not deflation'

In China, we note that consumer prices rose 2.5%, year-on-year, in January (vs. expectations of a rise of 2.4%, and from 2.1% in December). Of possibly much more significance is the fact that Chinese producer prices increased by 6.9%, year-on-year, in January (vs. expectations of 6.6%, and up from +5.5% in December). So if we think back through this report, it does appear that inflation is picking up in a number of countries. We already know that China's imports of crude oil, iron ore, coal and other industrial materials have resulted in higher commodity prices generally in recent months. The bears would have us believe that China is about to see a tightening credit squeeze, and that their growth overall is slowing, while 'hard commodity' bulls talk about an imminent onslaught of infrastructure spending globally. In our Outlook document, we commented that the copper price, for instance, had probably risen too far, although any correction (below about $2.60/lb) should be bought into. Turning to Ms Yellen's prepared comments in her testimony last week (about inflation surveys), we subsequently note from one of our sources that the Federal Reserve Bank of New York survey of consumer expectations released last Monday found that year-ahead inflation expectations in the US increased to 3.0%, from 2.8% in December and 2.5% in November. The expectation for three years ahead was 2.9%, up from 2.8% in December. Added to all this we have seen the Citi Global Inflation Surprise index rise into positive territory in recent weeks, to a reading of 9.86, the highest level since late 2011, and which is beginning to look like a trend change. The gold price perked up, and then came off. At school we were taught that increases in PPI feed through into CPI statistics when pricing power exists. In each cycle – and we have opined this could be an elongated one – the factors contributing to commodity price trends are different. **We will report back to you.**

INVESTMENT SUMMARY: At the very end of the 'Economic & Investment Outlook' chapter of the recent NBAD Global Investment View 2017, we wrote: "Norges, the largest sovereign wealth fund, is known to be increasing their equities exposure, and we expect others to probably be doing the same". Last week it was announced that the Norwegian government has decided to submit to parliament a recommendation to increase the equity share in the Government Pension Fund Global ('GPFG') to 70%, from the current 62.5%. The government will also propose a downwards revision of the expected real rate of return of the fund from 4% to 3%. They said, "The expected return on equities exceeds that of bonds, thus supporting the aim of increasing the Fund's purchasing power. At the same time, equities carry higher risks…", before concluding that, "All in all, the government considers an equity share of 70% to carry acceptable risk". The recommendation to increase the equity share of the GPFG will be presented to the Norwegian parliament on the 31st March. This is very interesting because this formal announcement by the Norwegians will create a stronger precedent for other SWFs to make similar moves, and underlines that we live in an increasingly equity-friendly world. The reduction of the estimated future real return on the GPFG is also instructive, probably recognizing that while they prefer equities over bonds, equities may not be that cheap historically, and that should bonds enter a bear market from these levels of still very low bond yields, overall average absolute returns would fall. Without immediately reading too much into this announcement we are nonetheless very excited by it, as for many years the accepted median/typical pension fund split between equities and bonds (ignoring for the moment real estate and alternatives) has been 60:40. **While SWFs are individual and have their own specialist mandates, any tendency towards 70:30 for the 'average' fund will have significant (if gradual) implications for global securities markets.**

Our Asset Allocation Committee meets later this week. In the meantime, our investment strategy remains unchanged.

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