From West to East

Weekly Investment View

26th February, 2017

Staying long in equities

The recent 'staying power' of the S&P500 has been impressive, with ten 'up' days during the last 11 trading sessions (for the Dow Industrials it has been 11 out of 11). The S&P closed at a record 2,367.34, up 0.72% on the week, and is up 6% for the year-to-year (and about 10% since the US elections), with the whining of the bears getting ever louder. Although Fed Chair Yellen has spoken publically since, the markets were still hoping to get further clues regarding the outlook for US rate increases from the publication of the minutes for the FOMC meeting held on 1st and 2nd of February. These noted that "many" FOMC participants anticipated a rate hike "fairly soon", if inflation and labour market data are in line with expectations, with "a few participants" seeing an advantage to hiking "at an upcoming meeting." The minutes also noted that participants see uncertainty about the fiscal outlook. US equity markets also took it in their stride that the time horizon for the actual delivery of the Trump Administration tax and spending packages was in effect being pushed out. At the same time, continuing uncertainties in European politics led to a degree of caution (Marine Le Pen has promised that France would leave the euro should she become President), and safe haven demand pushed gold up by 1.8% over the week, to $1,257.19. To an extent consistent with this, the yield on the 10-year US Treasury bond closed just over 10 basis points lower, at 2.3117, while the 2-year US Treasury yield fell 4.5 basis points, to 1.1428%. German 10-year bunds were notably strong, with the yield coming off by 11.6 basis points, to 0.186%, largely attributed to investors' aversion to French government bonds - and the German 2 -year yield fell by 13.6 basis points to a historic all-time low of minus 0.946%. Despite the concerns, the EuroSTOXX 600 closed flat (+0.04%), with the euro 0.50% lower vs. the dollar. The dollar index closed at 101.09, up fractionally over the week. **We continue to be happy to be overweight in US and European equities in our asset allocation, with the euro currency exposure fully hedged.**

"The Trump Administration's timescales just became more realistic"

So what has actually happened in the Trump policy timescales, relative to what the optimists had been expecting? Speaking on CNBC, Treasury Secretary Mnuchin said his aim is to have the tax reform completed in time for Congress' August recess, but that it is too early to give details on the exact plans. This may yet be a disappointment considering Trump's early February promise to unveil a "phenomenal" tax plan in the near-term. In reality, although the markets are still keeping faith with and looking forward to the new Administration's avowed intentions to bring about very business-friendly reforms, investors are probably taking some of what the President says with a pinch of salt. Meanwhile, Mr Mnuchin is quietly building credibility by beginning to lower the expectations bars, and to engage in worthwhile damage control in the event that his boss over-promises. Trump commented last week that the tax reform plan was "nearly done", and that is would come after they had dealt with the repeal of the Affordable Care Act ('Obamacare'), the overhaul of which should be ready by the end of March. Mr Mnuchin said the Trump administration was committed to passing a "very significant" tax reform plan before the Congressional recess in August, and that he expected the plan would be instrumental in increasing

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annualized GDP growth to at least 3%, effective next year. Again, these are timescales that investors can begin to identify with in terms of what might be possible, with a growth target that is not off the top of the page. Furthermore, Mnuchin once again made comments about the dollar almost certainly designed to keep it under control for the time being. A strong dollar, he said, would be a reflection of confidence in the US economy, and a good thing. Regarding the Border Adjustment Tax, Mnuchin said they are seriously considering it, although it has negative as well as positive aspects. President Trump is scheduled to give a speech to a joint session of Congress this Tuesday (28th February), and we hope it doesn't contain too much background noise. With US equities having run ahead so consistently, we are nonetheless aware of the possibility that the small retracement we expected when we wrote the 'Outlook' could materialize after all. **Based on what we know to date, events surrounding the new US Administration are more or less taking shape as we thought, so believe that any correction that does occur should**

be seen as a buying opportunity. In addition, we are encouraged to see more of a sector rotation taking place (incorporating broader participation), as it had not seemed realistic that the so-called 'Trumpflation' sectors (Financials, Industrials, Materials and Energy) should continue to outperform week after week.

Turning to the Federal Reserve minutes, these indicated that "many" FOMC members are expecting rate rises "fairly soon". There is much more detail, but this is the essence, and with it being clear that members had reflected quite deep-seated uncertainty regarding their expectations about the possible impacts of the new Administration's fiscal policy. Separately, last week, Federal Reserve Bank of Cleveland President Loretta Mester had said she is "comfortable" with a rate hike now, with the Philadelphia Fed's Patrick Harker arguing for keeping the March rate-hike option on the table. Fed governor Jerome Powell also made similar comments, indicating that March is 'live'. Just over a week ago the usual Bloomberg-based analysis reckoned the probability of a March hike was 34%, and at the end of last week this had risen to 40%, with a 61% likelihood for May, with June standing at 73%. The current reference band for the Fed funds rate is 0.50-0.75%, and we are staying with our expectation in the recent 'Outlook' that this would be in the target range of 1.25-1.50% at the end of this year (i.e. a total of three 25 basis point moves). **Such an expectation by itself should not damage the outlook for most risk assets, and Janet Yellen and her colleagues will not want to be the team that definitively left the Fed 'behind the curve' on rates.**

"Europe's politics are looking somehow familiar"

In European politics, there are three weeks to go before the Dutch elections, and Geert Wilders, right-wing populist, has had to stop making public appearances due to security concerns. He is leading in the polls, although if he won would face the problem that most of the other parties are refusing to join a coalition with him. In Germany, polls are showing that Chancellor Angela Merkel's ruling party are now trailing the Social Democrats; Federal elections must be held before 23rd October, and the consensus taking shape appears to suggest that Mrs Merkel's political days are numbered. In France, Francois Bayrou of the Centre Party has announced that he would not run for president, and instead back Emmanuel Macron, putting the national interest first in an attempt to keep Marine Le Pen of the National Front out. Meanwhile, both Le Pen and Republican Francois Fillon are facing allegations that they misused public funds, with Le Pen refusing to be interviewed regarding this. Like Le Pen, Italy's Five Star Movement want to take the country out of the 19-nation euro. Italian general elections must take place sometime before 23rd May next year. These questions are beginning to weight on the euro, although the euro/dollar pair is holding above the 1.05 level (last at 1.0563), probably due to the existence of already large short positions. Set against Europe's political developments is the fact that the Citi Economic Surprise index for the Eurozone last week rallied very sharply to the 71.9 level, the highest reading in four years. This is a very clear summation of how recent economic results have come in relative to what continue to be very moderate expectations. **We are drawing a more or less direct link between this Citi index and the technical configuration of for instance the DAX index, which appears capable of going to new all-time highs sometime in the near future – and against the seeming political odds in the bloc.**

In global bonds, the US 10-year Treasury yield range remains intact at 2.30%-2.65%. We advocated a trading buy at the upper end and now it is trading at the lower end of that range, where we would take profits on investment grade credits in the A/AAA space. MENA new issuance continues at breakneck speed, with Majid Al Futtaim tapping a hybrid perpetual tier-1 bond, as well as Bank of Sharjah (BOSUH) looking at a new benchmark 5-year senior unsecured tranche. MENA sovereigns in the region are also looking to issue with Kuwait, Saudi Arabia and Dubai all said to be in discussions about potential transactions. **Last week was good for MENA bonds, with price action favouring investment grade with narrowing spreads in a year that has been dominated by outperformance in global High Yield. Oman announced the issuance of 5, 10 and 30-year bonds late last week.**

INVESTMENT SUMMARY: The NBAD Asset Allocation Committee met last week, and decided to leave existing investment policy unchanged. We are recommending an underweight position overall in global bonds, although favouring High Yield, an overweight in global equities, favouring the US, Europe (and India and MENA – specifically the UAE – in emerging markets). We are underweight in alternative assets, via underweights in hedge funds and commodities, although continue to hold a hedge position in gold.

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