From West to East

Weekly Investment View
9th July, 2017

Investment policy remains ‘risk-on’

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The S&P 500 index was steady last week, up 0.12%, at 2,425.18, hovering 1.2% below the record all-time close of the 19th June, and is up by 9.1% for the year-to-date, led by Information Technology. So far, this is a vindication of our ‘risk-on’ strategy recommended in the Global Investment Outlook 2017. Emerging Market equities have done even better, with the MSCI Emerging Markets index up by 17.7%. The Barclays Aggregate Bond Index is only up 1.9%, year-to-date. Importantly last week, US June non-farm payrolls increased by 222,000, compared to a revised 152,000 for May, and vs. expectations of 178,000. Wage growth continued to be slightly disappointing. The renewed discussion of the previous week regarding when central banks as a group might begin to reverse their QE programs and normalize interest rates continued, and concerns regarding this increased. The downside in global bonds triggered the previous week by remarks from Mr Draghi, ECB President, continued last week, once again led by German Bunds, which reacted badly to a weak French debt auction, and US Treasuries followed. The large up-move in the 10-year Bund yield to just under the 0.50% level at the end of the previous week had arguably resulted in a very oversold condition for Bunds, after which one might have expected some respite. However, the Bund yield closed even higher, at 0.5730%, up another 10 basis points, partly due to consideration of the ECB’s June meeting minutes, which confirmed a willingness to consider slowing its rate of bond purchases sooner than earlier expected. The yield on US 10-year Treasuries also rose by 10 basis points, to just under 2.39%. In 2017 the spread of the 10-year US Treasury yield over the 10-year Bund yield has narrowed from 2.22% at year-end to 1.83% currently, probably mainly a function of the improving relative growth outlook in the Eurozone vs. the US, and now the realization that the ECB will ‘taper’ sooner after all. **All that said, though, and - as our fixed income colleagues in Asset Management have said - the lack of inflation, despite reasonable growth, is likely to contain the upward move in yields for the time being.**

“Nervousness in bonds has not de-railed equities”

Elsewhere in the equity markets, these also moved narrowly last week, with the Europe STOXX 600 index ahead by 0.24%, and Japan’s Topix was 0.30% lower, despite a good Tankan manufacturers survey. Chinese equities were broadly unchanged. Overall, nervousness in bond markets has not rattled global equity markets, and our ‘risk-on’ stance remains unchanged after last week’s Asset Allocation Committee meeting, which left investment policy unchanged. Turning to foreign exchange markets, the dollar was 0.33% firmer in terms of its index (at 96.008), with the euro/dollar pair closing on its 1.1400 resistance level. As difficult to gauge as ever, the dollar/yen closed at a two-month high of ¥113.92. The Bank of Japan (BoJ) stands alone amongst major central banks with monetary accommodation in place, not in any way indicating that they intend to reverse it anytime soon. Japanese bond yields had been dragged upwards slightly during last week’s bond moves, but the BoJ stepped in with a general bid at 0.11% to cap it in their own market. In oil, WTI reversed to the downside, closing $1.81 lower (at $44.23) over the week, after a run of nine up-days; with participants for instance concerned that Thomson Reuters Oil Research showed OPEC’s exports in June rose to 25.92 million barrels/day, an estimated increase of 450,000 bpd from May. Lastly, gold closed $32.7/oz (or 2.6%) lower over the week, more reflecting the firming in rates and a technical breakdown in silver, than stabilization in the US dollar. **There is even talk in the markets that bitcoin should be viewed as an increasingly serious competitor to the yellow metal, needless to say a view that we cannot agree with.**

“The US suffers from a skills shortage – so wage gains are stifled”

The gloss was partially removed from the good headline US non-farm payrolls number by the fact that wage growth continued to disappoint, with earnings up 0.2% month-on-month, or 2.5% year-on-year. Commentators continue to look for seemingly low unemployment (which although slightly higher last month, at 4.4%, remains close to a 16-year low) to provoke better wage growth. The headline 222,000 job gains were 47,000 more than reported in the previous two months, a good number,

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driven by gains in healthcare, government, restaurants and professional & business services sectors, according to the Labor Department. A US unemployment rate of about 4.7% appears to be what the Federal Reserve considers to be ‘full employment’, and in the old fashioned ‘Phillips Curve’ sense economists still expect low unemployment to put upward pressure on wages, which would in turn bring about inflationary pressures. **For some time we have placed more emphasis on the looser definitions of the percentage of workers employed, such that we believe a figure of 4.4% considerably understates it; in all probability a high percentage of the jobs being created are low-salary jobs, as well as employers suffering from a skill shortage – they would like to fill higher-salary vacancies, but cannot find sufficient candidates.**

“We expect a pickup in US economic performance”

In other US economic data, the Institute of Supply Management (ISM) said its index of manufacturing activity rose to its highest level in almost three years, with a reading of 57.8 for June, up from 54.9 in May, and more importantly vs. market expectations of 55.2. While a good number, it should be remembered that manufacturing only accounts for about 12% of US GDP. So we were much more excited to see that the ISM Services index (services are about 75% of the economy) increased to 57.4 in June, compared to 56.9 in May, and vs. expectations for a fall to 56.4, according to Thomson Reuters. This was broadly confirmed by IHS Markit’s services sector activity index, which rose to 54.2 last month, from 53.6 in May. Following the ISM data the Atlanta Federal Reserve is reported to have raised its forecast for US second-quarter GDP to 3.0% annualized, from 2.7%. **Accordingly, it looks as though the 1.4% rate of GDP growth reported for the first quarter is increasingly likely to have been a low point in growth, and the Citi index of US Economic Surprises could continue to rally from its very low recent level – which *ceteris paribus* would be good for dollar stability in the immediate months ahead.**

“Mario Draghi could be correct about the end of European deflation”

In the Eurozone, retail sales increased by more than expected in May, according to Eurostat, driven by stronger sales of clothes, shoes, and fuel for vehicles; sales rose by 0.4% month-on-month, and by 2.6% year-on-year. In other data, IHS Markit’s Eurozone manufacturing PMI rose to 57.4 in June, up from 57.0 in May, and the highest since April, 2011. This was a very good number. Regarding Eurozone unemployment, this was unchanged at 9.3% in May, still high in absolute terms, although at the lowest level in eight years, again according to Eurostat, who also reported that ‘core’ inflation picked up, to 1.1% year-on-year, from 0.9%. **These numbers are all consistent with a better economic performance, yet also reflect the endemic unemployment problem (especially for young people) that exists.**

“We are focusing on investment positives – globally, and sector by sector”

INVESTMENT SUMMARY: The G20 Summit in Hamburg ended with what has been described by some as a ‘face-saving’ declaration of unity, papering over the divergence of President Trump’s views on climate change and trade from the residual ‘G19’. The G20 communique noted the decision of the US not to participate in the Paris climate change agreement, and to allow members to take legitimate action in trade disputes. One of the important takeaways from the G20 Summit will surely be that irrespective of the views of Donald Trump, the world will continue to evolve, and without him and the US. In effect (unless we consider the possibilities of Trump resorting to brute force in geopolitical situations), the US has decided to step away from many aspects of global leadership, and at a time when there is no shortage of global leaders willing to fill that void. Without getting overly philosophical, although the US economy remains very important in global terms, this abrogation of responsibility on the part of the US is occurring at a time when the rest of the world is seeing – in many instances – improving growth, and a degree of political stability, excluding specific potential flashpoints. At this point, the world and its leaders are looking increasingly capable of making progress irrespective of whatever paths the US chooses to take, and a policy of ‘containment’ seems likely. Also, economics is taking the baton from blunt politics as a driver of investment markets. **New players in investment markets are coming into the frame – such as in China, or India – alongside a degree of improvement in Europe – rather than the markets being totally US-led.**

“Information Technology remains an overweight”

The Asset Allocation Committee met last week, and will meet again later this week. It was decided to keep the overweight in Information Technology (longer term, investors need the growth inherent in this sector) and to weather any short-term correction. It’s global PE-to-Growth has risen to 1.64 x for 2018, from just 1.11 x last November when we wrote positively about the sector – and the ‘E’ (earnings) have grown usefully due to earnings beats and positive forecast revisions of them. **The positive stance in Financials Services was also underlined, which could also benefit further from any swing towards ‘Value’ sectors.**

“We expected a correction in equities – but markets continue to climb”

As our readers will be aware, we have been hoping for a 5-8% correction in equities – and this simply hasn’t happened. The negative Trump factors (the overall delay to his initiatives and continued ‘background noise’ related to him) have failed to rattle the markets – and THAT suggests a strength of momentum that has been a factor keeping the AA Committee ‘risk on’ in terms of its investment policy. **Meanwhile, other good things are happening: Europe and the EM world are taking greater leadership in terms of their contribution to global GDP growth – and without so far creating the kind of inflation that would be damaging to the present value of future earnings.**

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