From West to East

Weekly Investment View
16th July, 2017

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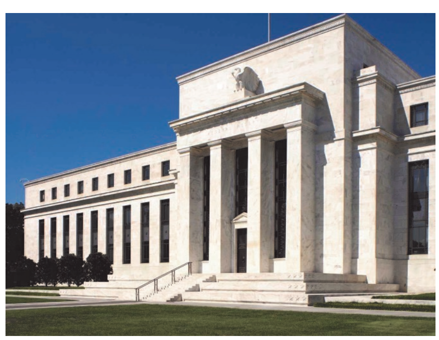
Locking-in profits ahead of summer uncertainty

The S&P 500 closed at a new all-time closing high of 2,459.27 last Friday, up 1.4% over the week, and European stocks did even better, with the Euro STOXX 600 index closing up 1.8%. The key driving factors appear to have been that in her Congressional testimonies last week, Fed Chair Janet Yellen made it clear that she and her colleagues were now not so resolute in their opinion that subdued inflation (below 2%) in the US may not be so 'temporary' after all, and that rates "would not have to rise that much further" to achieve a more neutral level. Normalization and a reduction in the size of the Fed's balance sheet will proceed, but seemingly more gradually than the market perceived a few months ago. As if to drive home the inflation point, CPI data from the Labor Department for June missed market expectations, coming in at an annualized 1.6% for the headline rate, and an unchanged 1.7% for the 'core' rate (excluding food and energy). The particular inflation data series favoured by the Fed (the Personal Consumption figures from the Commerce Department) have recently been coming in 0.3-0.4% below the Labor Department data. Ms Yellen sounded frustrated that inflation was not firming towards their 2% target, despite what they have described as a tightening labour market. The key end result was a swing to a dovish (fewer tendencies towards rising rates) interpretation by the markets from this latest Yellen message, in contrast to the more hawkish interpretation following the last set of Fed minutes.

A possible lower target for the Fed funds rate (and more monetary accommodation for longer) would be a favourable backdrop for business and equities – although not for banks, who stand to benefit from the so-called 'endowment' effect of higher rates on their lending. So although the major US banks reporting their quarterly earnings beat expectations, their stock prices were marked lower, underlining this rate logic. Deregulation in the banking sector should help their potential earnings capability in time. Also supportive of the more moderate rate expectations was the fact that US retail sales for June came in below expectations, falling 0.2% month-on-month. What will have also capped the upside in rate expectations last week are Ms Yellen's remarks (to the Senate Banking Committee) in Day Two of her testimonies to the effect that she thought it would be "quite challenging" for the US to reach the 3% growth target set by the current Administration. According to Bloomberg's model analyzing Fed funds futures data, there is now only a 43.4% probability of a rate hike this December, down from about 52% prior to the inflation and retail sales data. The yield on the policy-sensitive US Two-Year Treasury note fell by just over 4 basis points over the week, to 1.3556%. **The key takeaway is that moderating inflation and interest rate expectations are good for markets, provided there is no overshoot to the downside – and provided political considerations don't get in the way.**



"The Fed will still reduce monetary accommodation and raise rates - but very prudently"

The Fed still anticipates it will start reducing its balance sheet "this year", according to Chair Yellen, although the market now has some doubts about whether the Fed will in reality deliver the four rate hikes they are currently forecasting before the end of 2018 (i.e. one this December, and three next year), especially as the Fed has a track record of not enacting forecast hikes in recent years. In last week's testimonies the oft-mentioned 2% inflation target was once again pushed-out to the 'next couple of years'. Meanwhile, against the perceived adjustment in US monetary background described, the US dollar weakened further on its index, which fell another 0.8%, to 95.14. The yen was stable against the dollar, while the euro firmed 0.4%. Even sterling was relatively strong against the dollar, with cable closing the week at $1.3088. In other markets, WTI gained 50 cents, to $46.54, as commentators weighted a mixture of news – with the latest US oil inventories data showing a good drawdown, but set against other news suggesting that OPEC/NOPEC production restraint was weakening, with apparently improving Chinese demand not sufficient to rally prices. In other economic statistics, China reported better-than-expected trade data for June, with exports rising 11.3% from a year earlier, and imports growing by 17.2%, both beating market expectations – and resulting in a trade surplus of $42.77 billion for the month. In other China news, Fitch Ratings maintained the sovereign ratings of China at 'A+' with a 'stable' outlook, said to reflect the strength of China's external finances and macroeconomic track record. The near-term growth prospects for China remain favourable, Fitch said. **It is also worth mentioning that the Bank of Korea revised its forecast for South Korea's 2017 GDP from 2.6%, to 2.8%, contributing to an increasingly positive economic view of the region.**

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"A less aggressive investment policy stance now looks appropriate for the time being"

INVESTMENT SUMMARY: Following the meeting of the Asset Allocation Committee last week, it was decided to make a series of (mainly inter-related) changes to investment policy, most of which had already been discussed at length during the last three or four meetings. As our readers will appreciate, they constitute tactical, rather than structural strategic changes, which will hopefully become apparent from the passages below. Our stated overall thesis of being 'risk-on' (essentially overweight in global equities, and underweighted in bonds - although with a trading bent) explained in our Global Investment Outlook 2017 has worked well for the year-to-date. The MSCI World Index is ahead by 12.5%. Admittedly we could have been overweight in Emerging Market equities (rather than 'neutral'); within that we have overweighed Indian equities, which have done very well, and which we are still comfortable with. The Barclays Aggregate Bond index is only up by only 2.3% for the year-to-date. We have not done so well with our bullish call on the US dollar, and have given back some performance via being fully hedged in the euro-based positions; the Committee is mindful of this, although wasn't in favour of closing this last week at what was perceived to be a 'dollar-oversold' point. To have been underweight in Alternatives (commodities and hedge funds) has worked so far. In the interest of time and space here are summaries of the changes made, and the main logic behind them:

(1) To reduce the overweight in US equities: For the time being the best quarterly corporate earnings growth comparisons have passed; no market proceeds upwards for months without a break, and US equities are now quite overdue a good correction. In the short-term a delay to the new healthcare bill is looking more likely, further delaying other regulatory and tax changes that investors have been hoping for. Trump's well-documented troubles now appear more likely to provoke a sell-off, even if (to quote Warren Buffet) the US "still has the secret sauce".

(2) To reduce the overweight in European equities: Many global fund managers have been piling into this asset class upon the realization that although structural problems remain, favourable valuation metrics (vs. the US and elsewhere), plus the some good news (e.g. Mr Macron) could be sufficient to inject some life into what has long been deemed to be a 'dead' asset class. This move is predicated mainly upon a presumed knock-on effect should the correction in US equities mentioned above materialize.

(3) To reduce the underweight in 'Govvies' (developed market government bonds): Many investors began the year worrying about a possible end to the 35 or so year global bond bull market, a function of (mainly US) stimulatory measures to come that would in the short-term stretch government finances and lead to increased inflationary expectations. The latter have been moving to the downside. A break above 2.60-2.65% in the US 10-Year yield is a pointer we have been using. Global Govvies yields could now quite easily break downwards, rather than upwards.

(4) To go neutral in MENA equities, from overweight: We still like this asset class on a medium-to-long term view, starting with the logic regarding cheap valuations, and factoring-in economic advancements (e.g. in terms of diversification) in the region. Nonetheless, on balance the Committee is concerned that in the event the oil price trades towards $40 during the thin (volume-wise) summer months, volatility could pick up, producing a good opportunity to once again go overweight at lower price levels.

(5) To increase the overweight in Asia Pacific ex-Japan equities: A few months ago the Committee initiated an initial overweight in this sub-class, which includes China, South Korea, Hong Kong, Taiwan, Singapore, Indonesia, Malaysia, Thailand, and the Philippines. This region clearly has superior growth from a global perspective, and defines the societal and economic improvements that prescient investors are looking for. So while slimming positions in other global equity markets it was decided to increase the commitment, and as it has worked so far.

(6) To go neutral in the IT sector, from overweight: We have been positive on this sector for some months, pre-dating Outlook 2017, and have so far remained with the overweight, given good (obviously US-led) results, and the weight of money sitting on these corporate balance sheets. Nonetheless, the still high-beta nature of the sector dictates that any US equity-led downside volatility could cause quite a correction, a glimpse of which we saw a few weeks ago. Longer-term we still like the sector very much, especially as the growth rates offset higher P/E ratios.

(7) To go overweight in the Healthcare sector, from neutral: Demographic factors contribute to excellent medium-to-longer term fundamentals, while it can be said that this broad sector has something for a range of client risk profiles (including biotechnology). P/E ratios in the region of 16x on average for next year appear well-deserved. From a US viewpoint the watering-down of Trump's healthcare bill replacement (as we expect) should be bullish for a sector that for too long has been beholden to politically-based perceived risks.

As a result of the above changes, the asset allocation grid is now neutral in global fixed income, only moderately overweight in global equities, underweight in alternatives, and slightly overweight in cash. The Asset Allocation Committee meets again in two weeks. Summer 'proper' can be a very tricky time for markets, and while the broad trends in equities have been especially bullish for this year so far, we are wary about extrapolating them too far in terms of our expectations. Sometimes it is better to be positioned less aggressively, even if there is a possibility that short-term bullish equity trends persist. **Taking less risk can be the 'pause that refreshes', as one researches new ideas, sectorally and geographically, with the ammunition being available when it is needed.**

"The Trump Administration's policy agenda clock is ticking…"

Lastly: the US Senate healthcare debate and vote has been delayed by at least a week, as Senate Republican leader Mitch McConnell was apparently not assured that revisions made to the bill published last week would be sufficient to secure the 50 votes needed to pass the bill in the Senate, out of its 52 Republican senators. It does look as though - once again - every vote will count, right down to the wire. Senator John McCain is currently at home resting after unscheduled eye surgery, and he is one of the remaining Republican 'holdouts', and who is said to be working on yet further amendments to the latest bill with one of his colleagues. **It had been hoped by senior Republicans that the new healthcare bill could be disposed of well before the August Congress recess, to facilitate progress on other matters – like tax reform…**

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