From West to East

Weekly Investment View
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Onto the next US hurdles

The S&P500 index rose 0.6% over the week, to 2, 472.54, a fraction below a further all-time high set last Thursday, despite mixed earnings reports (General Electric was a particular disappointment, also Goldman Sachs) and a late reversal for energy stocks followed oil prices lower. The Euro Stoxx 600 fell 1.7%, as further euro strength (to a two-year high of 116.63 - after 1.1683 - against the dollar) greeted Mario Draghi's statement after Thursday's ECB policy meeting, which was not considered sufficiently dovish to reverse the short-term trend. The ECB President talked in terms of sustaining monetary accommodation until that policy had done its job of stimulating inflation; accordingly, interest rates were left unchanged. We had expected him to talk the euro lower after its recent run, although he singularly declined to do so, and traders added more long euro positions. The dollar index fell by a further 1.3% over the week, to 93.858, also given growing concern that Trump's policy agenda is getting increasingly bogged-down following the latest delay to the finalization of health-care reform, with extra distraction resulting from expanding Russia-linked investigations. The yen strengthened to 111.13 vs. the dollar; the Bank of Japan board voted by 7-2 to keep policy unchanged at a short term rate of -0.100%, and once again pushed out its 2% inflation target date (to 2019). The German 10-Year Bund yield fell by just over 9 basis points over the week, to 0.5060%, with yields on comparable issues in some peripheral markets falling by twice this amount. The yield on the US 10-Year Treasury fell by 9 ½ basis points, to 2.2375%, with market participants clearly having made up their minds about prospective US growth and inflation (i.e. that any stimulatory economic policy to come was being pushed more firmly into 2018). The usual Bloomberg analysis of Fed funds futures suggests a 40.3% probability of a rate hike in December, down about 3% over the week. **It is also perhaps interesting to note that China raised its holdings of US Treasuries for the fourth month in a row, with commentators linking this to the more stable renminbi of recent months, reflecting the fact that Chinese foreign exchange reserves rose for a fifth month in June; China is the second-largest holder of US Treasuries after Japan.**

"Our positive Asia-Pacific (ex-Japan) view continues to pay off"

Elsewhere in the markets, we note that the MSCI Asia Pacific ex-Japan equity index rose a further 1.2% over the week (to 524.78), closing in on its all-time high reached in late 2007. Within this, Chinese equities rose by a further 0.6% (on the CSI 300 index), although China's main small-cap/ venture capital indices continue to reflect a gently calibrated credit squeeze designed to take risk out of the Chinese financial system. Early last week official data showed that China's second-quarter GDP grew at an annualized 6.9% rate, slightly ahead of forecasts of 6.8%, so if this rate is sustained the country might be able to achieve its first year-on-year improvement in GDP growth since 2010. We have cautioned during the last few years that the real number could be a percent or so lower than this, but we also note that the authorities have openly acknowledged the problems they have experienced in the compilation of such data. More detail on the latest figures is available. Despite an ongoing effort to isolate and deal with pockets of internal debt, and to de-risk the economy (e.g. in financial services), underlying optimism is underpinning Asian shares, and – to an extent – commodities. Certainly metals prices firmed on the back of the Chinese data. While we don't expect a return to the commodities 'Super-Cycle', in time some of the knock-on benefits of good Chinese growth may follow, once they have better-addressed more of their own over-capacity issues as part of the transition to a more consumer-led economy. In the markets, there has been growing investor discussion of selectively increasing exposure to non-US (and especially EM) currencies. Even if US growth potential is being pushed further out, China and its Far-Eastern trading partners appear to be stepping-up to fill any gap – and they will be trading more between themselves in future. Meanwhile in those markets, South Korea's Kospi index closed the week at a fresh all-time high, and Hong Kong's Hang Seng index has also been doing very well, although not yet at all-time highs. **The Asia-Pacific growth theme is not new to our readers, and we will continue to tread carefully in our recommended portfolio allocations in this area, but it is certainly worth continued effort – and while many international investors find themselves dragged in this direction; when markets do well it doesn't always presage disaster – and when fresh all-time highs occur there is no overhead resistance.**

"US health-care is unbelievably complicated"

The deeper we have got into the subject of the politics surrounding US health-care legislation – the more we have understood just how complex it is. Just over a week ago, Mitch McConnell, the Republican Senate house leader knew he would have to allow prolonged discussion. The unhappy situation regarding senior Republican, John McCain (whereby he has had unexpected surgery for brain cancer), underlines how much the whole discussion within the Senate rests on a knife-edge. Republicans control the Senate 52-48, and it only takes a few of them not falling in line to block a vote – and in the case of Obamacare repeal and replacement, this is a very divisive subject. Since repealing the previous Act without an immediate replacement means delaying the effective repeal for up to a few years (possibly) while detailed policy discussions take place, that is what will almost certainly happen. At the time of writing the exact nature of the so-called Better Care Reconciliation Act proposals are unclear, and we now wonder how it was ever thought such legislation could be dealt with fairly rapidly, so as to clear the path for the passage of tax reform and cuts, and infrastructure (and other) spending proposals. Some Republicans are saying the initial Trump Administration plan on health-care didn't go far enough in cost savings, while some - with mid-term elections now coming into view – realize they will have to face their voters in the knowledge that a collective 20 million people or so (up to perhaps 32 million) will lose their health insurance, and in addition that costs will rise for many with private coverage. Moderate Republicans are finding themselves thinking more like Democrats. Some Republicans still want a complete repeal of Obamacare, including the related taxes and insurance regulations that came with it. Others have been very vocal regarding continuing to provide cover for people with pre-existing conditions. Republican leaders will want to progress work on tax reform irrespective of an ongoing health policy debate, and we may hear more along these lines this week. A few commentators are expecting that even a basic repeal (with a long delay) could get blocked in the Senate. Certainly the Republican Party must move on, and as soon as possible, to changing the tax code, increasing the nation's debt ceiling, and the passing of next year's spending bills. In the meantime, as John McCain messaged last week, Congress must "hold hearings, receive input from members of both parties, and heed the recommendations of our nation's governors" to pass a health-care plan that works. **The implications of last week's log-jam in health-care are further considered in the last section of this week's report.**

"The level of the euro does remain key to ECB monetary policy"

Mario Draghi, ECB President, was careful how he chose his words in his statement following last week's ECB meeting, following his belief that his comments regarding the eurozone's economic recovery and the 'end of deflation' last month had been misinterpreted (i.e. too hawkishly). Some commentators had expected some indication this time regarding how and when the ECB's monetary accommodation would be 'tapered'. However, the bank had apparently held back from having discussions over the timing of reigning-in its quantitative easing, and in the meantime Mr Draghi said the asset purchase program would continue. He said tapering would be up for discussion in the autumn. He sounded disappointed that the economic recovery in the region had not yet resulted in higher consumer prices. We had fully expected him to talk the euro down, as mentioned above. Instead, in merely saying the euro's recent strength had received "some attention" (on the part of commentators), this was received like a red rag to a bull by traders, who interpreted this as a green light to average-up. Monetary stimulus would remain in place "until the end of December 2017, or beyond", and until inflation is on a clear upward path. He said, "A very substantial degree of monetary accommodation is still needed for underlying inflation pressures to gradually build up". The current asset purchase program is set to expire at the end of the year. Indeed, "The last thing that the Governing Council may want is an unwanted tightening of the financing conditions". **Mr. Draghi's efforts to make it look as though he wasn't particularly bothered about seeing strength in the euro seems to be part of a continuing ploy to keep the market guessing, in all probability buying time to effectively delaying the reality of reducing the size of the ECB's balance sheet until well after the Fed has begun the same process – thereby keeping the value of the euro lower than it might otherwise be in the future to boost exports. Also, given inherent remaining weaknesses in the European banking sector, and across much of the 'periphery', he knows that eurozone interest rates must be kept as low as possible for the foreseeable future.**

"Investors have pushed-out when they expect positives from Trump's agenda"

INVESTMENT SUMMARY: Firstly, regarding the provision of health-care in a developed or emerging-developed country, this is almost certainly best done via a nationalized service to provide the basics, with some top-ups – and it is expensive, but should not be anywhere as expensive as it has turned out to be in the US. This is best achieved in a mixed, rather than highly capitalistic economies, and has to be paid for mainly out of taxation. In the US, in this subject, political moderates and ultra-conservatives need to agree, and that may not happen easily in the months ahead. **So far, investors have discounted most of the immediate lack of progress in US health-care legislation , and in reality for some months have been pushing-out their expectations regarding when the positive aspects of Trump's agenda (such as tax cuts and reform, and less regulation hampering business) would actually kick-in.**

"The good news is that at least Medicaid spending remains in place"

The Trump Administration had thought the health-care issue could be dealt with quickly, and that the cost-savings could be used to fund tax cuts and the rest. Investors are now facing the possibility that the US debt ceiling decision could be delayed, or perhaps very delayed. Thinking this through a bit further, Republicans will want to use 'reconciliation rules' to pass a tax bill, as there may not enough votes in the Senate to get through the 60-vote hurdle. However, our understanding is that this reconciliation route needs Congress to pass a budget resolution, and this may not happen quickly, delaying any tax bill. We are not saying we think the worst scenario will happen (i.e. policy paralysis), but until investors are able to see past the hurdles more clearly, US equities may find it difficult to make much further upward progress. **At least in the meantime, Medicaid spending will continue, and investors are once again looking at the broader health-care sector positively again, and in any case on a global basis.**

"With health-care static, Republicans will now switch to better legislative prospects"

Between now and the end of the year, the US Congress still has to approve more than $1 trillion in federal spending, and get through a debt ceiling increase to avoid a government default - all in the space of about a dozen working weeks, after the August recess. The Republicans are aiming to outline their tax reform principles by the end of this month, have them studied by members of Congress in August, and to release a plan in September for further consideration. In the markets last week the reduced prospect of fiscal expenditure was good for bonds, and following a run of soft US inflation data lessening the possibility that the Fed would remove stimulus in the immediate months to come. For the time being, investment policy remains unchanged, having recently increased the weighting in bonds to a neutral position, at the same time as having taken some profits in developed country equity markets, so reducing the overall overweight position in equities. **The Asset Allocation Committee meets again at the end of this week.**

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