From West to East

Weekly Investment View
2nd July, 2017

Into the summer..

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The bell-weather S&P 500 closed 0.6% lower over the week, at 2,423.41, still just 1.2% below its all-time closing high of 19th June, with weakness in technology stocks (now taken by the market to include companies such as Facebook, Apple, Amazon and Netflix) not fully offset by a late rally in large US banks following good Federal Reserve stress-test results. The S&P Technology sector leads for the YTD, being ahead by 17.3%, vs. 9.3% for the S&P500. Telecoms and Energy are both down by more than 10% over that period. Concern earlier in the week that Senate Republican leaders had delayed the vote on healthcare legislation until after the 4th July holiday faded towards the weekend as financials and energy stocks rallied. The banking stress-test results went hand-in-hand with remarks made by Janet Yellen in London to the effect that she didn't expect to see another significant economic meltdown in her lifetime. In effect, the Federal Reserve has allowed the largest US banks to pay out most of their earnings this year as dividends, with a figure totaling about $100 billion being mentioned. Elsewhere, after the recent mainly Macron-led gains in eurozone equities, the STOXX Europe 600 index fell by 2.1% over the week, not helped by a firmer euro. Significantly, global bond markets traded lower last week, with the yield on the bell-weather US 10-year Treasury closing at 2.3037%, a rise of just over 16 basis points, which compares with a rise in the 10-year Bund yield of 21 basis points (to 0.4660%). The latter appears to be a move to the upper boundary of the range, rather than a breakout to the upside. **The US 10-year yield remains contained within an approximate 2.15-2.60% range, which we have been referencing for some months as being pivotal for markets.**

"Draghi misinterpreted – or was the euro just too strong?"

Investors and commentators are getting the sense that (especially following the way Mario Draghi's comments from last week have been interpreted), the other large central banks (except the Bank of Japan) would really like to curtail their monetary accommodation in the way the US Federal Reserve already has – to the point where a growing consensus could be taking shape (bearish for many global bond markets). All tied up with this, of course, are perspectives on the US dollar vs. its peers. Readers will be aware that the US dollar has recently been weakening in terms of its index (last at 95.628), now down by 7.4% from its high of 103.30 in late December. A greater degree of negative US economic surprises as defined by the Citi index of that name now compares far less favourably to what is happening in Europe, where a measure of economic improvement is taking hold. In a journalistic and investment sense too much could be being read out of the words of central bank policy-makers during recent weeks. At the bottom-line, though, most central bankers want to be prudent, and not just print money – they saved the financial world as we know it, but at some point the accommodation must be reigned-in. Mario Draghi did give a fairly bullish assessment of the eurozone economic situation, fueling speculation that an ECB tapering of asset purchases might follow sooner than expected. This has come at a time when many investors are still underweight in (for instance) European equities, and thinking they should buy into any weakness – and especially if the euro may not be doomed after all (helped by the pro-EU policies of Mr Macron). Of course there remain other obstacles, notably the Italian elections, and the finalization of financial arrangements regarding Greece. **For the time being we remain tactically overweight in European equities, ex-UK.**

Further to the ECB saying Mr Draghi's comments had been misinterpreted, their displeasure was probably underlined by the related strength of the euro – which could if sustained harm eurozone exports. Thinking more globally, policy-makers will want to avoid a repeat of 2013's 'taper tantrum' and the damage it caused. Accordingly, any QE reversals are likely to be made very slowly indeed. **While we have been broadly correct so far this year regarding a 'risk-on' stance (overweight global equities, and underweight bonds), it is right and proper that we now re-assess our bullish Global Investment Outlook 2017 position regarding the US dollar.**

"US economic growth forecasts have begun to reflect political realities"

At the end of last week, better-than-expected data for US personal income and first quarter GDP (this was revised upwards from 1.2%, to a 1.4% annualized rate) helped investment sentiment, countering poor May durable goods numbers earlier in the week. A few weeks ago the International Monetary Fund reduced its estimate of GDP growth for the US economy, essentially removing the previous reflationary assumptions relating to what was earlier expected from the Trump Administration's policy agenda; the IMF reduced its forecast for US growth this year to 2.1% (from 2.3% in April), and to 2.1% (from 2.5%) for 2018. While earlier this year we had cautioned that investors should not expect too much too soon from the Trump Administration in terms of effective policy rollout, we accept there have been distractions (for instance a delay with healthcare reform), and despite the best efforts of Mr Mnuchin (Treasury Secretary) and his team, they are in reality coming to terms with the enormity of the overall task before them. In a previous report we said we expected the IMF would have to reduce its estimate for US growth; as their estimate now stands, they are clearly expecting the annualized growth rate to improve a bit further during the course of this year, and for that to be sustained into next year. **We anticipate a tax reform package will go before Congress next year, and it should pass as most are in favour of it.**

"Don't forget the massive potential in India"

India's Sensex index is ahead by 16.1% for the YTD (to 30,921.61), and we still very much favour Indian equities for the medium-term. In our asset allocation we used the announcement of Modi's demonetization initiative last November as a buying opportunity, and although neutral in emerging market equities overall, we remain overweight and tilted towards India within that broad asset class. Mr Modi, the Prime Minister, now looks assured of a second term in office, and economic growth prospects look better than the vast majority of countries globally. Sure enough, there have been some political obstacles for Mr Modi, but he is now doing much better, and has properly understood that he had to look after the rural masses, not just the elite classes. Near-term drivers are the 7^{th} Pay Commission implementation, and the benefits from a better monsoon, as well as the implementation of the long-awaited nation-wide Goods & Sales Tax (GST). We have, like many others, been impressed with the way inflation has been reduced, to 2.2% currently, down from above 10% just a few years ago. The ways in which demographics should drive consumption are arriving as expected, going hand-in-hand with urbanization. The rising penetration of financial services is bullish, as well as the increasing ability of the Indian finance ministry to ensure that taxes are paid – which in turn assures the funding of significant infrastructure (and other social) expenditure. Like China, India has a high domestic savings rate, further enabling the funding of growth. Leading fund management house Kotak expects about 16% earnings growth for the 2018 and 2019 financial years, while valuations approximate 18.5x and 15.6x earnings for those years respectively. **To reiterate, we remain bullish of Indian equities, also helped by the much-improved outlook for the rupee, currently trading steadily at 64.50 to the US dollar.**

"Oil is still in the $45-55 range – having failed to make a downside break"

Oil closed last week at $46.04, basis WTI, having bounced from a recent closing low of $42.53. Investors are concerned that reductions in OPEC & NOPEC production will continue to make way for increased US shale-based production over time, and especially as technological innovation continues to progress. If the Baker Hughes rig count does fall from here (it fell by two last week, after rises for many weeks), that is all well and good, but many shale operations are cash flow positive down to $20-25/barrel. Otherwise, there appears to have been a pick-up in production in Nigeria and Libya (exempted from last year's agreement). Although down last week, US production has risen by about 10% over the past year. It may take longer (into next year) for the global oil market to rebalance. OPEC (and NOPEC) action could result from the 24th July meeting in Russia, with some OPEC delegates suggesting that several options are currently being discussed, including deeper production cuts, although there is residual skeptism about this. The US Energy Information Administration (EIA) reported that US crude inventory increased by 118,000 barrels last week, while weekly production declined by 100,000 barrels per day (as mentioned), to 9.3 million bpd. Our news sources suggest recently strong demand from China. **Overall, prices are back in the $45-55 trading range that we have been talking about for some time, having unsuccessfully tested the lower boundary of it.**

"Some rotation into out-of-favour sectors could now be tactically appropriate"

INVESTMENT SUMMARY:

Last week's downside moves in global bonds were positive for the model portfolios, given our underweight stance across the broad asset class. The Asset Allocation Committee meets later this week, and will review weightings (and especially equity sector weightings) in some detail. For instance, Healthcare is due to be discussed, alongside the regular discussion regarding our Technology overweight. Separately, it has been good to see our (admittedly so far restrained) positive stance regarding Chinese equities being borne out, helped by the inclusion by MSCI of 222 onshore-quoted ('A') Chinese equities in their emerging market equity indices. **We will report back in next week's issue of the FAB Weekly Investment View.**

For any inquiries related to this article, please contact Clint.Dove@nbad.com

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