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First Abu Dhabi Bank

From West to East

Weekly Investment View

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US economy takes the shine off equity markets

Equities continued to outperform most other asset classes last week, with the US stock market leading the others. The S&P500 closed up 0.1% over the week, slightly below Tuesday's all-time closing high of 2,440.35. The NASDAQ Composite closed 0.9% lower over the week, however, reflecting broad weakness in technology stocks, and others that are now characterized as such. Recent negative events concerning President Trump remain in the back of investors' minds. Last week saw nearly 200 opposition democrat lawmakers bring a lawsuit on Trump, alleging there are conflicts of interest with the US presidency giving an unfair advantage to Trump's global business empire. This comes hot on the heels of last week's Senate intelligence committee hearing from the former director of the FBI, James Comey, who was recently fired by Trump while he was leading an investigation into possible Trump Administration relations with the Russians and the latter's potential involvement in last year's US election. Comey's hearing did not did not immediately result in anything newly negative for Trump, although towards the end of the week Trump tweeted a conformation that he is now under formal investigation regarding the obstruction of justice. So deliberations are continuing over the probe of national security advisor, Michael Flynn, who expressed surprise that Comey had elaborated further on Trump and Russia, while a former FBI director and special counsel, Robert Mueller, has been tasked with taking the investigation forward. **As mentioned, however, markets chose to ignore any possible negative repercussions from this and most other political factors, in favour of economic developments such as a discussion of whether the FOMC is likely to stay the course regarding further intended US rate hikes.**

"A canary in the coal mine for US tech stocks?"

Last week saw a fairly sharp three-day correction in the NASDAQ Composite. Technology stocks have had one of the longest periods of gains since the tech boom peaked in the year 2000. It finally succumbed to profit-taking, with a fall of 8% over two days last week, leaving investors wondering whether this was just a correction, or the beginning of something more ominous. This is perhaps not surprising, given that some of the largest and best-known stocks listed on the NASDAQ have very high P/E multiples, reflecting high expectations for future earnings potential. In 2000 the NASDAQ crashed; back then, 'telephone number' earnings expectations went hand-in-hand with business plans in the so-called 'dot-com' boom that were often very weak – or non-existent. It's a very different landscape now, with many high-profile US tech firms like Apple not only having major market shares, but also the ability to generate very large free cashflows, which are continuing to build huge cash piles on the balance sheets of the sector's balance sheets, in turn bolstering valuations. In the case of Apple, cash flow per share stands at over USD $12/share, and the company has cash and near-cash balances of approximately $67 billion. On Friday, Amazon, the fast-growing online retailer announced the surprise $13.7 billion acquisition of health supermarket chain, Whole Foods. Amazon is another classic example of a company that generates serious cash (of about $1.66 billion per annum in free cashflow). The acquisition of Whole Foods has generally been viewed as positive by the market, as it is seen as further strengthening Amazon's overall position in retailing. While a correction in technology (including what is now regarded as technology in the broad sense) cannot be ruled out, the long-term fundamentals remain very positive in an industry that constantly reinvents itself with every innovation. **The Asset Allocation Committee last week voted to remain overweight in technology, within the context of continuing overweight in US equities as a class. Global equity markets have continued to ratchet higher overall, at the expense of many other asset classes. Having said this, we are cognizant that risk sentiment generally remains slightly cautious, demonstrated by the US 10-year Treasury trading below 2.20%, at 2.15% at Friday's close – and having been as low as 2.10% on Friday after data suggesting US inflation may not be as high as first thought, and upon further reflection following last week's widely expected 25 basis point Fed funds increase.**

"Theresa May has a mess to clean up"

Last week we covered the UK general election result, which left the Conservative party with a reduced 317 seats in the UK parliament (of the total 650 seats), resulting in what is described as a 'hung parliament', in which the largest party cannot govern without the support of one or more of the others. Theresa May, the UK prime minister, is yet to form a coalition with Northern Ireland's Democratic Unionist

Party (DUP), who have been largely in favour of her policies. Hard bargaining with the DUP is now the order of the day, especially as Brexit negotiations are about to get underway with the European Union. Boris Johnson, UK Foreign Secretary, has denied reports that he intends to challenge May for the leadership of the party. This caused sterling to drop from the weeks high of $1.2978, to close at $1.2783. In the short-term, pressure remains on the currency due to the result, which could complicate Brexit and weaken the UK's bargaining power. UK economic performance has been robust, however, in the face of all the uncertainty. Sterling has recovered from last year's lows, but could nonetheless see a period of volatility in the short term with respect to the Brexit negotiations, and also while Mrs May attempts to bring about a more stable domestic political background. We will watch closely how this will play out in the months ahead. German Chancellor Angela Merkel has been quick to rule out a 'stay of execution' while the UK leadership gets its house in order. The DUP has not yet confirmed that they are actually ready to form a coalition, something that had been intimated as a done deal by May and her team. Last week the Bank of England (BOE) also met to decide the course of UK interest rates. In that meeting it was decided to keep the benchmark rate at 0.25%. What was more interesting was that the vote was not unanimous. Three of the eight voting members of the Monetary Policy Committee were in favour of immediately raising rates, compared with market expectations of just a one-vote minority in favour of such a hike. **The fact that sterling has not collapsed is probably due to the scope the BOE has to raise rates if necessary, and also the thought that a coalition government is more likely to lead to a so-called 'soft' Brexit, rather than a very disruptive, 'hard' one.**

"The Fed is pushing ahead with rate normalization"

All eyes were on Janet Yellen, Chair of the US Federal Reserve, on Wednesday. As widely predicted, the FOMC raised the Fed funds rate by 25 basis points, to 1%. This was despite the fact that US economic data has weakened of late, and borne out by lower US consumer confidence numbers last week. However, there is near full employment in the US, along with headline CPI now being above the Fed's 2% target should see this happen. The fact that 'core' inflation weakened was downplayed by the Fed as being 'temporary'. Recent events concerning President Trump has caused some to speculate that the Fed might pause on increasing rates if he were to face impeachment. In James Comey's testimony submitted last Friday, he outlined that Trump had asked him to drop an investigation into former National Security advisor, Michael Flynn, who had been dismissed over his misleading account of contacts made with a Russian ambassador. This of course related to potential interference by Russia on last year's US election process. James Comey left no doubt that he believed Russia had interfered in the election. This initially caused some unease in markets that was later swept aside and viewed as having no lasting impact on the president. The dollar has been on the back foot since the allegations including being worried about a follow through in Trump's re-inflation policies that were dealt a blow after a watered-down $1.1 trillion budget was passed through Congress last month. The situation in North Korea continues in the background, with all these events helping to push the Dollar index (DXY) to a low of 96.32 last Wednesday. This recovered somewhat at the end of the week, closing at 97.274. **The recent risk-off sentiment eased, with US Treasuries selling off, and the 10-year yield rising to 2.16% at the week's close, and with gold $14 lower over the week (at $1,252/oz).**

"France to clear the way for a common EU economic policy framework"

It is expected that today Emmanuel Macron will be handed the French Presidency. The French are voting for the fourth time. What remains is how much of a majority Macron will gain. His REM party could sweep up to 80% of the seats being contested in the 577-member national assembly. That would be the biggest landslide victory in a quarter of a century in the country, and would set a very good backdrop for France being underlined as a key stakeholder in the EU after the UK's probable exit. Macron has floated the idea of a common European economic policy, in the form of a more harmonized framework of policy for EU members, something that has been difficult in the past. Unlike Donald Trump, he has been a champion of climate change. His proposed cabinet members have been viewed as very strong. Key members from the former centre-left have also moved to back him. Polls suggest voter turnout may be very low, with just 47% of the electorate expected to cast their votes today. No further nationwide elections are now expected until at least 2018, when Macron is expected to push through many of his reformist policies that should be good for the country – and arguably for Europe as a whole. Macron's victory looks set to rival the last big landslide, that of Jacques Chirac's Fifth Republic party. Back then, Chirac was head to head with the united Socialist party that held most of the legislature. Macron's opposition looks set to be split among several parties, all facing difficulties that could give him the clear advantage. Other bold measures he proposes to make include changes to the French tax code that would cut labour costs while liberalizing it at the same time. The outcome of Germany's Federal elections later in September will be key to Europe's ambitions going forward. **The Asset Allocation Committee remains overweight European equities, reflecting a continuing improving theme playing out in Europe, despite structural obstacles. French government bonds last week managed to close the gap on German Government bonds in a continuing sign of improving confidence following positive political developments in France.**

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