NBAD

From West to East

Weekly Investment View

5th March, 2017

Taking cues from the speeches

The markets began with an almost eerie feeling that if investors didn't soon receive some 'small print' regarding the Trump Administration's policies - and preferably in the President's inaugural speech last Wednesday - then a market correction might ensue, especially as an early week chorus of Federal Reserve officials signaled very clearly that the US Fed funds rate should rise this month. Perhaps unsurprisingly, Trump's speech delivered little by way of details, as the new Administration clearly needs more time to engineer policy specifics that will be credible, especially given the planned extent of them. This speech was made against the background of Democrat calls for new Attorney General Jeff Sessions' resignation over claims that he misled the Senate regarding the nature of any contact he had with Russian officialdom in the period before the election. During mid-week the S&P had a rare down-day (we had been hoping for some, to restore a sense of normality, despite being bullish). Yet the equity market downside was short-lived, with futures markets eventually factoring-in a 94% probability of an FOMC rate hike this month (up strongly from a 36% reading at the end of the previous week), and the S&P500 index closed up 0.70% over the week. European large-caps did even better, being up 3.01% on the week, despite ongoing machinations in the run-up to the French elections. Japanese equities rose 0.50% over the week. The dollar was 0.94% firmer in terms of its index, buoyed by Trump's speech and the rising rate hike expectations, after a few weeks during which some of the dollar bulls began to get disappointed at the pause in upward progress. The yield on the policy-sensitive 2-year US Treasury note rallied by just over 16.3 basis points over the week (to 1.3051%) , while the yield on the 10-year Treasury closed up 16.6 basis points (to 2.4780%). Set against the equity bullishness, gold closed 1.8% down, at $1,234.81. Oil was little changed, at $53.33 for WTI, within a maintained pattern of unnaturally low volatility. **In summary, what we saw last week seemed to be a slew of so-called 'bullish divergencies' for equities, when one might normally have expected a bearish result, thus underling the momentum behind current market action. We remain overweight in developed market equities, especially in the US and Europe (and selectively in the emerging space), although accept the logic suggesting that some further broadening of equity participation is due.**

> *"President Trump offset a perceived lack of detail by an otherwise flawless performance"*

Trump's speech was always going to be important for the markets. Probably the key point is that he came across as being presidential. His mode of delivery was almost flawless, and he hardly missed a beat. He was confident, patriotic, and conciliatory - even if unsurprisingly the Democrats weren't accepting any of it. In terms of content, this was essentially a reiteration of the new Administration's known intended policies, including the repeal and replacement of the Affordable Care Act ('Obamacare'), a $1 trillion infrastructure plan (to be delivered over ten years), a 10% defence spending increase (already leaked the previous day), a further crackdown on immigration and the building of the Mexican wall. On the debit side, investors were hoping for some discussion of financial services (and other) industry regulation reductions, together with impending changes in taxation policies (including the border adjustment tax), together with more than a hint of how the sum total of planned expenditure was going to be paid for, as well as the cuts that would need to be made elsewhere. As mentioned earlier, the work of Trump's senior advisors continues, and we are still confident that the financial minds that have been hired will deliver; the financing aspects are unlikely to be entirely conventional, but that should be expected. The initial response to the speech in the markets was strangely neutral, but then turned positive, suggesting that Trump had survived the test. Sure enough, investors do now need a steady diet of Trump specifics; fortunately, especially Treasury Secretary Mnuchin fully understands this. The bottom-line was that the markets wanted to see a believable, reasonable, and more measured Trump, and that is arguably what they got. So the Trump 'reflation trade' is back on (it was never off in our view), although expectations regarding the speed and profitability of it need to be kept realistic. **Lastly, although the President repeated the need to keep drug prices under control, he did say he wanted the Food & Drug Administration to reduce drug approval times, a positive for the pharmaceutical (and certainly the biotech) sectors, the latter of which we referred to favourably in our recent 'Outlook'.**

Claude-Henri Chavanon

Managing Director
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> *"For Yellen and her FOMC colleagues, the markets have said it's OK to move"*

In a week of important speeches, Fed Chair Janet Yellen also gave one on Friday, before going into the 'quiet period' before the upcoming 14th-15th March FOMC meeting. As you can imagine, this was met with great interest, especially given the immense increase in rate rise expectations last week. Although the speech was largely referring to the historic conduct of Fed monetary policy, we couldn't but help feel that her concluding comments had in a real sense been 'signed-off' by the markets, with a 94% priced-in probability telling the FOMC that it's 'OK to hike', and fully discounting the move. Indeed there would now be disappointment if they did not. We reviewed the transcript and think the important takeaways are as follows: She said, "Looking ahead, we continue to expect the evolution of the economy to warrant further gradual increases in the target range for the federal funds rate. However, given how close we are to meeting our statutory goals, and in the absence of new developments that might materially worsen the economic outlook, the process of scaling back accommodation likely will not be as slow as it was in 2015 and 2016". "A useful concept… is the 'neutral' real federal funds rate, defined as the level of the federal funds rate that, when adjusted for inflation, is neither expansionary nor contractionary when the economy is operating near its potential." Continuing, "Last December... most FOMC participants assessed the *longer-run* value of the neutral real federal funds rate to be in the vicinity of 1%... reflecting, in part, slow productivity growth and an aging population not only in the United States, but also in many advanced economies". "… With the actual value of the real federal funds rate currently near minus 1%, a near-zero estimate of the neutral real rate means that the stance of monetary policy remains moderately accommodative…". **Reading between the lines - and knowing their measure of inflation is just below the target, and that the basic measure of unemployment is at or very close to being at 'full' - the Fed's officials know that unless they begin to raise rates now they'll be left behind the curve, especially if Trump's policies begin to kick-in constructively.**

Ms Yellen continued: "My colleagues and I generally anticipate that the neutral real federal funds rate will rise to its longer-run level over the next few years. This expectation partly underlies our view that gradual increases in the federal funds rate will likely be appropriate in the months and years ahead…". In our opinion, investors should underline 'months', however also 'gradual', with the latter being something that makes the markets very comfortable, given that investors have already accepted that in the absence of some unforeseen disaster, normalization has to happen. Of course if the Fed does subsequently find it needs to move faster, it will - yet the realization last week that the new Administration will face more obstacles than it would like is not all bad, as it makes the overall transition to a more business-friendly environment safer and more measured, and less debt will have to be used. Furthermore, Yellen said, "On the whole, the prospects for further moderate economic growth look encouraging, particularly as risks emanating from abroad appear to have receded somewhat" (this had been a central argument for back-pedaling on rate rises last year). "…Core PCE inflation - which excludes volatile energy and food prices and, therefore, tends to be a better indicator of future inflation - has been running near 1.75%...", and "…In light of current economic conditions, such an increase (*i.e. 0.75% - three rises this year, our italics*) would be consistent with the Committee's expectation…". She went on, "…my colleagues and I expect the neutral real federal funds rate to rise somewhat over the longer run, (therefore) we project additional gradual rate hikes in 2018 and 2019". "To conclude…the economy has essentially met the employment portion of our mandate and inflation is moving closer to our 2% objective". "I continue to have confidence in our judgment that a gradual removal of accommodation is likely to be appropriate. However, as I have noted, unless unanticipated developments adversely affect the economic outlook, the process of scaling back accommodation likely will not be as slow as it was during the past couple of years". **So as of last Friday night, we read 'three hikes for this year', in line with our Outlook expectations, and we don't expect these to be disruptive for the markets.**

"Indian GDP data generation is still being perfected"

Last week saw the publication of official Indian GDP data for the fourth quarter of calendar 2016, with annualized growth said to have fallen to 7.0%, from 7.4% in the third quarter, and vs. expectations in the region of 6.0-6.4%. Earlier assumptions had been that the hit from the demonetization of 86% of India's currency last November had been severe, given the apparent overall effect on consumption and services following the daring move to counter the very large black economy. Our reading (and common sense) suggests that official estimates could not adequately measure what is actually happening in the so-called 'unorganized' (essentially cash-using) sectors, as data is by definition mainly derived from the 'organized' sectors. Also there was a statistical effect due to the GDP growth estimate for the fourth quarter of 2015 being revised downwards by an annualized 0.8%, making for an easier comparison. We suspect that revisions will be made to official figures in the quarters to come. **Fortunately, the underlying investment logic that we documented in the 'Outlook' remains very much in place, and Indian equities have performed well since November. Lastly, according to Kotak, if one adjusts for the lack of profitability of the public sector banks, the market P/E ratio falls to the 16-17x region for the current year.**

MENA bond issuance continued apace last week. Majid Al Futtaim Holding LLC, rated BBB/BBB by S&P and Fitch, with stable outlooks, priced a $500 million 5.5-year non-callable perpetual bond, at a yield of 5.5%, down from initial higher indications. Expected ratings for the instrument were BB+/BB+ by S&P and Fitch. Qatar Reinsurance Company (QRe), the largest insurance company in the MENA region, mandated banks for a debut US$ perpetual bond issue. A debut USD denominated perpetual non-callable 5.5 year offering by QRe guaranteed by QIC should follow, subject to market conditions. Both QRe and QIC are rated A (stable, S&P), and the issuance is expected to be rated BBB+ by S&P. Bank of Sharjah PJSC, rated 'BBB+' by Fitch (and stable) priced a $500 million 5-year bond at a spread of 225bps over mid-swaps. Lastly, the Government of the Sultanate of Oman last week raised $5 billion of debt through a 3-tranche bond sale. The issuer priced a $1 billion 5-year bond at 190 basis points over mid-swaps. According to Reuters, the combined books for the 3-tranche deal were in excess of $19.5 billion, with orders skewed towards the 10 and 30-year bonds. **The above offerings have generally been well -received; these are all quality issuers, continuing to underline the positive overall development of MENA bonds markets.**

INVESTMENT SUMMARY: The NBAD Asset Allocation Committee meets later this week, until which investment policy remains unchanged.

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