From West to East

Weekly Investment View

12th March, 2017

Taking some money off the table – purely tactically

The S&P500 recovered some ground last week, to close 0.44% lower, at 2,372.60, taking heart from the good US Non-Farm Payrolls report for February. For the month and year-to-date, Information Technology is leading in terms of the S&P US sector returns (at an absolute 1.5% and 11.5% respectively), while the laggard has been Energy (at -1.8% and -7.4% respectively), hit by recently soft oil prices. The most important data out last week was the Payroll data for February, which rose by a very healthy 235,000, well ahead of initial expectations in the region of 190,000; also contained in the same report was news that annual wage growth had risen to 2.8%, from 2.6% the previous month, with unemployment little changed on the month, edging downwards to 4.7% (and compared to 4.9% a year ago). Two days earlier the US private sector ADP payrolls number came in extremely strongly, with an increase of 298,000 for February, way ahead of forecasts similar to those for the NFP, and after an upwardly-revised ADP number of 261,000 for January (vs. 246,000 previously). While the two data points don't move in lock-step with each other, the ADP lately appears to have been a better lead indicator for the NFPs. Having said that, investors want to see a US economy that is moving ahead nicely, but not running too hot (which could drive rates higher than the three Fed funds increases already priced-in for the current year). Accordingly the yield on the policy-sensitive 2-year US Treasury closed a few basis points lower on Friday, at 1.35%, for a rise of 4.8 basis points over the week as the markets breathed a sigh of relief. **Similarly, the closing yield on the US 10-year Treasury fell just over 3 basis points on Friday, to 2.57%, making an increase of just under 10 basis points over the week – and not yet signaling a conclusive end to the multi-year global bond bull market.**

"The Non-Farm Payrolls were good – but not too good!"

Looking at further detail in the NFP report, with revisions employment gains in December and January combined were 9,000 more than previously reported, and while not statistically significant in isolation it has long been appreciated in markets that various forms of 'revisions' indices can be very useful. Job gains last month occurred mainly in construction, private educational services, manufacturing, health care, and mining, so tending to be in areas of the economy that had been slack in prior months. Over the past three months, job gains have averaged 209,000 per month, a healthy number, and arguably consistent with a continual gradual reduction in the headline unemployment rate. The various probability calculations derived from futures market pricing suggests the almost total certainty of a rate rise from the Fed this week, and also underlines the total of three rate rises we expect for the current year. However, partly because most of this is now priced-in, the US dollar closed 0.29% lower on its index over the week, also influenced by a euro that was tending to be firmer, following ECB President Mario Draghi's comments more than hinting at an end of its QE, albeit in the distant future but consistent with a large 13 basis point upward move in the 10-year German Bund yield (to 0.485%). It was interesting to get the sense that the TLTROs (the ECB's long-term tenders to the banks) were unlikely to be rolled-over after their imminent expiry, a further sign that ECB monetary policy is indeed set to become less accommodative. Elsewhere, oil prices closed sharply lower on the week, 9% lower at $48.49/barrel for WTI, as US inventories continued to build to a new record, and market psychology turned more bearish in the short-term, with the perception that better adherence to agreed OPEC and 'NOPEC' output agreements is necessary (we expect improved demand to help turn the market in the second half of this year, and that the lower end of our forecast $45-60 trading range will hold). **Lastly, the Euro Stoxx 50 was 0.38% firmer over the week, helped by Banks, and also possibly influenced by BP, which has over the weekend been linked to Exxon in terms of a possible merger.**

Claude-Henri Chavanon

Managing Director
Head of Global Asset Management

It has been some time since we discussed Brexit, mainly due to the number of moving parts involved. However, as the UK will very soon trigger Article 50 to formally begin the exit procedure it is now worth spending more time to try to work out what the future might look like, for both the UK and the Eurozone. The UK will be expected to make some continuing contributions to cover historic liabilities, but the oft-mooted €60 billion 'exit fee' is an amount that we would expect never to be paid. The UK wants to control immigration, take back its sovereignty from Brussels, and yet retain access to EU markets in a cost-effective manner if at all possible. It will be a complex tapestry, and the UK cannot expect the advantages of the club if it is no longer a member. In the meantime the considerable fall in the value of sterling has kick-started exports and industrial production, yet has naturally also imported inflation. Manufacturing only accounts for about 10% of the UK's economy, while higher CPI inflation is hurting all UK consumers, evidenced by the pressures retailers are under pressure (net of the benefits from extra spending by visitors). Headline inflation has once again picked up, to 1.8% in January, from 1.6% in December, and is generally expected to be close to 3% by year-end. **Investors will be aware that UK equities have done very well in UK terms since last June's Brexit vote (mainly due to the shot in the arm for export earners), although foreign investors would have needed efficient and accurate currency hedging to have benefitted.**

"The UK economy has done very well under the circumstances"

It is true that the UK's economic performance has been very resilient since June's vote, and the OECD has just increased its 2017 UK GDP forecast to 1.6% (from 1.2%), noting the effectiveness of the Bank of England's monetary stimulus (although the OECD is staying with its forecast of only 1.0% for 2018). Meanwhile, the UK's House of Lords has voted to bring the final terms of Brexit before parliament for its approval, although Prime Minister Theresa May will attempt to overturn this (as well as another amendment regarding the rights of EU citizens in the UK). Last week the UK Chancellor of the Exchequer, Philip Hammond, set out the government's post-Brexit vision in his Spring Budget, against the background of the recent economic performance mentioned. He was able to quote the fact that the Office for Budget Responsibility (OBR), an independent fiscal watchdog, has increased its 2017 UK GDP forecast from 1.4%, to 2% for the current financial year (even if they now expect the economy to slow in 2018 and 2019, with growth at 1.6% in 2018). **The OBR also reduced its estimate for borrowing, now expecting a fiscal deficit of 2.6% of GDP for the current year, down from its 3.5% forecast last autumn (although they also said they saw no structural improvement in UK public finances).**

Neil Woodford, almost certainly the UK's best-known portfolio manager and with an excellent long-term investment track record, observed in a note last week that much of the austerity in previous Chancellor Osborne's plans has been "stripped-out", and that there is now more than £100 billion of extra borrowing proposed over the next five years than there was in Osborne's last budget. Woodford went on to say that the majority of the £16 billion 'windfall' (due to the better economic performance) was being put to one side to maintain flexibility later – and that "…the market consensus, in our view, has become too bearish in the aftermath of the Brexit vote". This Monday will see the publication of the draft law authorizing Mrs May to trigger Brexit. On Wednesday, Brexit Secretary, David Davis, will be questioned by the House of Commons Brexit Committee, and on Friday Mrs May will conduct a two-day conference in preparation for the triggering of Brexit at the end of the month. As one would expect, the BOE is expected to leave monetary policy unchanged this Thursday, maintaining a cautious approach into Brexit. **We still believe sterling has a fundamental medium-term value of $1.35-1.40, although cannot predict with any certainty whether a slightly better buying opportunity than the current $1.2167 will occur in the meantime.**

"The Uttar Pradesh landslide election victory is great news for Indian equity bulls"

As many of our readers will now be aware, Indian Prime Minister, Narendra Modi's BJP Party is understood to have won a landslide election in Uttar Pradesh, one of India's really key states, and the most populous. It is difficult to understate the significance of this result, as it provides a major boost for Mr Modi, and could be instrumental in him being able to win a second term in power. Almost four in ten voters are understood to have backed the BJP, whose position in the upper house of the Indian parliament should now be strengthened. The immediate harsh realities of demonetization must have hit Uttar Pradesh very hard, as it is a very poor state, yet this proved to be no obstacle to Mr Modi. **We continue to maintain our overweight position in Indian equities.**

INVESTMENT SUMMARY: The NBAD Asset Allocation Committee met late last week, and for various reasons decided to reduce the overweight positions in US and European equities - although on a purely tactical basis. We have held these positions for a number of weeks, with the original expectation that some of the headwinds to Donald Trump's - and also concerns relating to European politics or indeed any number of other factors - would likely generate an equity correction. However, it hasn't occurred. It isn't that we don't believe in the basics of 'Trumpanomics' - for we do - although we do recognize there are a few more impediments to the rollout of the new Administration's overall program than we had originally expected. The business-friendly nature of the Administration is by itself worth a higher P/E ratio on forward earnings than would have otherwise been the case. However, in the very short-term we cannot fully predict exactly how risk asset markets will react to the Fed funds rate rising next week, much of which will depend on the exact wording of the guidance which accompanies it. **We reiterate, we will remain overweight in US and European equities, just by not to the extent we were a week ago. We will allow the short-term factors, some of which we have mentioned above, to subside, with the expectation there will be a good chance that those monies can be re-applied to those markets at lower levels – with the major global equity uptrend remaining in place.**

"The US 10-Year Treasury yield is approaching significant levels"

Regarding bonds, the 2-Year Treasury yield has broken out to the upside, suggesting short-term rate expectations may well be behind the curve. On the 10-Year Treasury, we still expect the yield to remain in the 2.30-2.60% range we have been trading in recent months, suggesting that longer-term rate expectations are still 'anchored'. Having said that, if Yellen's statement is more hawkish than the three hikes we have assumed suggests, the 2.65% level could indeed be tested. Ms Yellen has swung from being relatively dovish at the start of Trump's presidency, to being more hawkish in recent weeks. We expect gradual 'normalization' to continue, rather than any reflection of inflation fears at this stage.

Any inquiries related to this article, please contact Clint.Dove@nbad.com or Alain.Marckus@nbad.com

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