From West to East

Weekly Investment View

21st May, 2017

Making it through a mid-week wobble

The S&P500 closed just under 0.4% lower over the week, showing composure after a 1.8% fall on Wednesday on market concerns relating to investigations being conducted by the FBI to shed light on possible Russian interference in last year's Presidential election and also whether Mr Trump asked James Comey (now ex-FBI chief) to shelve the Michael Flynn investigation. Such goings-on are seen as diverting the Administration from the important business of rolling out tax reform, infrastructure spending, and reducing red-tape for business. In addition the markets are looking for evidence that first quarter US economic softness is indeed transitory. Given the sense that a few headwinds do exist politically (and economically) for the Administration, market expectations regarding exactly how many rate hikes will be possible for 'normalization' purposes by the Federal Reserve (three for this year had originally been signaled) caused softness in the dollar, and at a time when the dollar index constituents have been buoyant for their own specific reasons. The dollar index closed 2.1% lower over the week (at 97.142), with market participants especially watching the euro as it strengthened to just above $1.12, the latter helped by perceptions that political risks (particularly nationalist 'tail risks') in the eurozone have fallen. Through all the above, and taking the lead from the US corporate environment, investors have been heartened by recent good results - both at the revenue and net profit levels - which have tended to come in above expectations, and that this overall factor is instrumental in determining stock prices. It has been a long economic cycle in the US, and there is still hope that Trump Administration policies will elongate it further, as well as adding new secular elements to it. **In addition, global investors have increasingly appreciated that although the US of course remains significant as a world economic driver, it is not the only one: growth and confidence in Europe has improved; although the nature of its sectoral contributions is changing, growth in China is still very good; and lastly, even Japanese growth has improved, irrespective of whatever longer-term structural impediments still exist.**

"Global growth is becoming better balanced"

In the face of what was mainly risk-off sentiment in the markets last week, the yield on US 10-year Treasuries closed 9 basis points lower, at 2.2346%. The US two-year yield, which is much more policy-sensitive, only fell by two basis points over the week, so on balance the markets still expect a degree of interest rate normalization from the Federal Reserve this year, even if futures markets-based measures now suggest a slightly lower probability that this will continue at next month's FOMC meeting. Coming back to the US 10-year yield, the main point here is probably that the 2.60-2.20% trading range that we have referenced for some time remains intact, thus perpetuating the status quo - in this sense, the overall calmness within trading ranges. Similarly, although the VIX index (indicating the implied volatility in S&P500 index constituents) shot up from 10.40 to 15.50 mid-week, it settled at just above 12.00, a level that is still historically very low. For the year-to-date, Information Technology leads the way (+17.1%), vs. +6.5% for the S&P, following an excellent results season. Over the same period Financials are essentially flat, and Telecoms and Energy are just over 10% lower. The 'higher rate expectation' premium in banking stocks in the US looks to be much reduced. Turning to the STOXX Europe 600 index, this corrected by just over 1% over the week, thus leaving recent profits intact following what looks to be a serious continued international rotation into European equities. Japanese equities were 1.3% lower, with the Topix index 1.3% lower over the week, also reflecting a higher yen (now at 111.26). China's CSI 300 equity index was 0.5% firmer, bouncing off its basically flat long-term moving average, and after a 5% correction from a recent high in mid-April; the authorities there are continuing to remove speculative fervor from various asset classes, and walking a fine line as they try to avoid a further blow-up in the shadow banking sector. Meanwhile, in Brazil, the indictment of President Michel Temer led to a 12% fall in

Claude-Henri Chavanon

Head of Products & Services
Wealth & Private Banking

equity values over the week (and 15% from the high early in the week); this is especially disappointing as there were high hopes that Mr Temer would turn the country around, based on his business-friendly policies, plus the fact this comes so soon after the 'Carwash' scandal. In oil markets, the price of WTI rallied by just over 5% (to $50.33), after (a) early in the week KSA and Russia indicated their support for extending output restraint until March next year, (b) US data showing inventories falling for the sixth week in a row, (c) US oil production fell for the first time in 13 weeks, and (d) market talk suggesting output restraint could be extended to oil products in an effort to accelerate rebalancing. **Lastly, gold rallied by 2.2% over the week, to $1,255.93, not managing to overcome offerings that prevented the approximate $1,264/oz overhead resistance being taken-out, prior to the next resistance likely just above $1,290.**

"The events unfolding in Brazil are very disappointing, especially after Rousseff last year"

As mentioned in our opening paragraphs, the events of last week in Brazil seem to have come as a genuine shock, completely

out of left field - even in Brazil. So much had been hoped for, following President Michel Temer being appointed as successor to the disgraced former president, Dilma Rousseff. As is to be expected, the nature of the allegations is complicated. As far as we understand, the two Batista brothers who own JBS SA, conducted an illegal transaction involving JBS, the Batista's family holding company, and state-owned banks and pension funds. The O Globo newspaper reported that Mr Temer was complicit in an attempt to pay a potential witness to remain silent (Eduardo Cunha, the former leader of the lower house of Brazil's Congress, jailed following his involvement in the so-called 'Carwash' scandal a few years ago). The Batista's have reportedly arrived at a plea-bargain, in which they have apparently provided many hours of video testimony detailing how they bribed many public and pension fund officials. Temer has been dragged in as the result of the deal reached between the Batista's and prosecutors. JBS and its owners have been huge donors in political campaigns in recent years, and it sounds like a very wide web of people is involved. JBS are said to have paid bribes to inspectors to facilitate the sale of contaminated meat. Coming back to Mr Temer, he apparently told one of the Batista brothers that he would have to keep up the payments to Cunha - and this was secretly recorded, and handed over to prosecutors. Although more and better information will surely surface, this series of events are a great shame, especially as the local Ibovespa equity index and the real currency were excellent performers last year. All this has led to calls that Temer, who has been president for just a year, must resign. He has denied any involvement, it must be said. **As Goldman Sachs has said, all this comes at a challenging time for the policy agenda, and the reformists' ability to enact fiscal reforms and to make other progress will likely have been weakened.**

"The IMF is positive on the economic outlook for the UAE, and what has been achieved here"

Non-oil GDP growth in the UAE is expected to recover this year, and after domestic economic adjustments made since oil prices fell, according to the IMF at the beginning of last week. They expect non-oil growth to grow by about 3.3% in 2017, from 2.7% last year. Including oil, they expect GDP growth to slow to 1.3%, vs. 3% last year, as the UAE reduces oil output in line with last November's OPEC/NOPEC agreement on oil production restraint. The IMF expects an improvement in global trade this year to help the UAE (which has a relatively open economy). Reuters reported that the governments of the seven emirates collectively tightened fiscal policy by about 9% of GDP in 2015, followed by a further 5% in 2016, with the implication that there could now be more flexibility, and/or that much of any necessary adjustment had been made. Infrastructure spending for the country as a whole is set to grow more slowly in the years to come, and the introduction of VAT next year will help fiscal balances. The IMF expects the UAE to eliminate its fiscal deficit by about 2022. It was encouraging to also hear that they expected substantial infrastructure spending by Dubai for Expo 2020 would be unlikely to adversely affect the emirate's finances. Dubai government (plus government-related enterprise) debt fell to 112% of GDP last year, from 126% in 2015. As expected, there will be a small fiscal deficit (it should fall to 4.5% of GDP this year) in the immediate years to follow, pre-the Expo. When we last did the back-of-the-envelope calculation, the oil and gas sector was thought to be about 24% of direct UAE GDP. **We continue to be bullish about the outlook for the UAE economy, especially from next year onwards; the economy is becoming more diversified than previously, with the possibility that non-hydrocarbon GDP growth could quite easily be in the region of 3-4% on average over the next five years.**

"Let's not forget that markets need to correct from time to time – and US equities have not done so"

INVESTMENT SUMMARY: The Asset Allocation Committee met last week, and had a lengthy discussion about the likelihood that the well-known political headwinds facing President Trump and his Administration (and the potential knock-on effects mentioned earlier) might finally provoke a worthwhile correction in US equities. When we published the Global Investment Outlook in January we said we expected at least a 5% correction, although as our readers will know, this didn't occur. The Conservative, Balanced, and Growth asset allocation model portfolios we use are overweight in US equities, within a risk-on macro framework. While we never like to 'tinker' with positions, the Committee exists to take worthwhile tactical decisions across asset classes. The members wanted to see whether the markets might bounce at the end of what had been a volatile and testing week, and to be as sure as it could be that the 8-10% downside required (to make it worthwhile to sell, and then buy back) was of a sufficiently high probability. The equity markets did indeed bounce on Friday, and the discussion continues. Although a decision was deferred, we nonetheless hope you find it interesting from a practical investment standpoint. The other overall point was that such a decision is a frictional and inter-related one, in that it begs questions about the fixed income, currency hedge (we have euro exposure hedged), and other aspects of the macro investment picture in our investment grids. We will follow-up. **In the meantime, investment strategy remains unchanged.**

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

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