NBAD

From West to East

Weekly Investment View

29th May, 2017

"Equities continue to climb the Wall of Worry"

The bell-weather S&P 500 index continued to make step-by-step progress to new all-time closing highs last week, finishing up a further 1.4%, and is now 8.5% ahead for the year-to-date. The NASDAQ Composite closed up 2.0% over the week, continuing to reflect Information Technology having had the strongest recent positive earnings and revenue surprises, with more and more commentators saying just how impressive the earnings momentum has been. This has gone some way to offset observations that a bubble is being inflated. Falls in Banking and Energy stocks held the STOXX Europe 600 index to slightly better than unchanged. Japan's Topix rose by 0.6%, held down by losses for oil stocks. In other major equity markets, the UK FTSE100 index closed at a new all-time closing high, up 1.0% over the week, driven mainly by a 1.8% weakening in sterling (to $1.2804) largely on the back of a narrowing of Prime Minister Theresa May's Conservative Party's lead in the polls to 5% (from a high of over 20% last month). China's CSI 300 index rallied by just over 1%, with investors mindful of next month's MSCI Emerging Market index review covering Chinese 'A' shares (i.e. onshore, rather than Hong Kong-quoted), rather than Moody's downgrading of China's sovereign debt to A1 (from Aa3). In US data, the upward revision in first-quarter GDP growth from an annualized 0.7%, to 1.2% was relevant in terms of the higher starting assumptions for current quarter growth, and the knock-on effect regarding the probability of a Fed rate hike at the June FOMC meeting. **Meanwhile, the minutes from the Federal Reserve meeting held earlier this month reinforced the sense that the majority of members wanted to hike/continue to 'normalize' rates, and that the discussion about starting to gradually reverse its QE before the end of this year was becoming more serious. The detail in the minutes made it clear that some FOMC members were concerned that exactly how such a decision is communicated must be handled very carefully, so as to minimize adverse market reaction.**

"Oil market observers are now wondering how the end of production restraint will be handled"

Regarding a Fed June rate increase, depending on exactly which method is chosen, the market-derived odds of this rose back above 90% last week. Such considerations helped the recently-weak dollar index (DXY) to put in a steadier performance (+0.3% over the week). Linked to this was the inability of the euro to break through upside resistance against the dollar at just below 1.12, following its rally in recent weeks from the 1.06 level. In fixed income, the bell-weather US 10-year Treasury yield closed a basis point firmer (at 2.2465%), with market participants inclined to see this as underlining continued 'risk-on' potential in other asset classes (a clear break of the 2.20-2.60% range to the downside would signal equity 'risk-off'). Turning to the more policy-sensitive US 2-year Treasury yield, this was just over two basis points firmer over the week (at 1.2937%), consistent with the Fed hike assumptions mentioned earlier, as well as with the measured bounce in the dollar. Oil prices were volatile during the week, including a $2.36/barrel fall (to a closing low of $48.90 on Thursday), before a close of $49.80 at the end of the week. The nine-month extension (to March, 2018) of the previous deal reached by OPEC/NOPEC had already been fully discounted, so it was largely a case of 'buy the rumour, sell the news'. Also, probably unreasonably, some observers expressed dismay that there had not been an even deeper overall production cut. Some remain skeptical of the whole arrangement, saying that (a) KSA has had to shoulder too much of the reduction, (b) US shale producers will simply continue to fill the gap, (c) Iran is continuing to increase production, (d) some producers have cheated, and (e) there is concern about what happens after the stated 1.8 million barrel/day production limit expires.

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It had also been hoped by some that output restraint could also include a move 'downstream' i.e. including oil products, with the thought that Saudi Arabia might take the lead in this.

"It is looking as though the dollar has reached a low"

INVESTMENT SUMMARY: Our Asset Allocation Committee has been relatively bullish about the US dollar vs. its peers since the summer of last year, yet the dollar (looking at its index) is now trading just below its level at the time Donald Trump and the Republicans won the US elections last November. One of the determinants of exchange rate pairs is relative real economic growth between the relevant countries, and investors' perceptions of these over the medium-term. Within developed markets, we expect the US economy to once again outperform the likes of Europe and Japan as and when a degree of extra fiscal stimulus and regulatory relaxation can be successfully applied. The US economy is at (or beyond) full employment, depending on one's exact definition of it, and consumer confidence remains at a high level, even if retail sales have been below-par in recent months. The US Federal Reserve in the minutes of its meeting earlier this month expressed the view that US first quarter economic weakness was transitory, and that the second quarter would see a rebound. **The minutes underline the basic desire of the majority of FOMC members to remain on a path of rate normalization, tempered as always by the 'data dependency' proviso.**

"Trump's lack of apparent progress has not prevented new highs in equities"

The Dollar Index (DXY) hit a closing high of 103.30 in late December, and has since corrected by almost 5.7%, influenced by (a) the rollout of the Trump Administration's reflationary policies meeting political resistance – and the probable reality that achieving quite so much by an early date was rather unrealistic in practice, and (b) the fact that economic surprises in the Eurozone and Japan have come in on the upside. Trump had wanted to get his new healthcare proposals through Congress first, before proceeding to his other agenda items, but the initial failure of this wasted time. As the President has admitted, his new job is more difficult than he expected. The resulting apparent lack of 'hard' policy execution, together with ongoing 'background noise' (spats with the media, plus the potentially more serious developments related to James Comey and whether Russia interfered in the presidential election) have held the dollar down. Recent talk of possible impeachment appears somewhat premature to us, although there are some Republicans (and investors) who would rather see Vice President Mike Pence with his hand on the tiller – at least some time after next year's Congressional elections. Turning to European politics, various election results have passed without any nationalist surprises, and Theresa May has called a 'snap' election for the 8th June. Mrs May is very likely to win this, making for a very much better-defined (although nonetheless very tough) period of Brexit negotiations. Although a degree of European political uncertainty remains (in Germany, Italy, and Greek issues), the overall world economy is seeing growth of above 3% underlined by IMF estimates. **The net result has been a positive effect on risk assets such as equities, and an investing environment that is at the same time quite fixed income-friendly: global growth is good, without being 'too' good, and short-to-medium term inflationary expectations remain below 2%. The latter will make it more likely that businesses will have pricing power, aiding corporate earnings growth (this has already been evident in the US SME sector, a very welcome development).**

"The 'Trumpflation premium' has disappeared – the slightest good news could bring some of it back"

In summary, rate differentials – led by US normalization almost certainly proceeding faster there than in Europe and certainly Japan – should favour the US dollar over other currencies. The 'Trumpflation' premium has largely come out of US asset prices, with expectations now quite low that he will succeed in reflating the economy; we believe this is probably over-discounted in today's DXY quote, indeed to the point from which it wouldn't take much good news to support and rally the dollar. Meanwhile, especially the yen has benefited from safe-haven flows, somewhat at odds with the ongoing structural difficulties Japan faces. We admittedly recently recommended the dollar at levels of just below 100 on the DXY, and we have not fundamentally changed our mind. Having said that, good trading lore would suggest that a break below the 96.80 technical level (on a 'close-only' basis) would lead us to question maintaining our bullish view. **For now, however, we remain dollar positive.**

"The Asset Allocation Committee voted to keep its 'risk-on' strategy"

In last week's report we described how our Asset Allocation Committee had at the end of the previous week discussed the possible wisdom of taking some risk off the table (in the main by reducing its overweight positions in equities). The other side of this particular coin is the Committee's underweight in global fixed income, although in terms of implied volatility it is the equity overweight that contributes by far the most risk. The discussion continued, and as our readers would expect this also begged questions about whether or not to keep the full hedge on euro exposure (i.e. whether to continue to expect the euro to underperform the dollar). These decisions went to a vote. A majority of members did not believe the markets are entering a 'risk-off' phase, with the small proviso that it was appreciated that the major European and US stock market indices did appear vulnerable to at least a short-term correction (taken to be 5% or less), although this was not sufficient to act upon (i.e. to have confidence that it would be worthwhile selling, with the intention of buying back in). On balance the Committee believed more equity upside would be seen in the coming months. **In other words, the members decided to stay with its bullish medium-term view on equities, having not thought that the required 8-10% downside move was imminent.**

"Recent euro strength does not change our expectations of seeing euro/dollar parity"

Regarding the dollar, of course the transcript above makes our stance clear. There was not a majority of members in favour of reducing or closing the euro currency hedge. The Committee collectively believes the recent rally in the euro/dollar is only an upward correction, and not a reversal in the dominant down-trend. Many of the causes of this latest rise (short-term disappointing US economic data, and diminished political risks and positive growth expectations in the Eurozone) appear to have already been taken into account in the exchange rate. Indeed the central view is that the euro/dollar would decline towards parity in the quarters ahead. **Accordingly, there appeared to be little reason to change the current Asset Allocation central scenario at this time, thus maintaining the major 'risk-on' positioning suggested in the Global Investment Outlook 2017.**

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