From West to East

Weekly Investment View
12th November, 2017

Catalysts for a market correction could be in place - but don't sell

By the end of last week there were signs of some investor nervousness in developed equity markets as it became clear that the crystallization of a Republican tax reform plan that President Trump would be able to sign could take longer, and that this may not happen 'before Christmas' as many had hoped. Congress's week-long Thanksgiving recess begins next weekend. As signposted earlier in the week, the Senate Republican version of the bill published last Thursday has corporate tax cuts taking effect one year later than envisaged in the House version, i.e. not until 2019; for most investors this is one year too long, when there has already been a delay, while some fiscal conservatives are still concerned about the effect on the potential increase in the US government's indebtedness of about $1.5 trillion. Meanwhile, some members of Congress are not happy with the reversal of the ability of states themselves to levy taxes. Such matters, together with the perception of growing geopolitical tension in the Middle East, kept developed equities in check last week: the S&P500 closed 0.21% lower over the week, admittedly not a significant fall, but the first after a string of new all-time highs achieved over the last two months, with the most recent only last Wednesday (at 2,594.38). The NASDAQ Composite mirrored that performance, closing 0.20% lower over the week. The S&P closed towards the middle of its Bollinger Band, suggesting the index is now neither technically overbought nor oversold. Unless new negative factors emerge, we regard this as healthy for the market, which needs time to consolidate its recent gains. The STOXX Europe 600 index fared worse, closing 1.86% lower on the week, affected by some poor corporate results. In Japan, equity prices performed in an intriguingly bullish manner, with the TOPIX index managing to reverse Thursday's initial large fall, to close 0.35% firmer over the week - and only 1% below the 26-year closing high of a few days earlier. The fiscal 2018/19 P/E ratio for the TOPIX is a moderate 14.7x, based on earnings growth of 8.1%, although with estimate revision looking set to improve further. Elsewhere in global equity markets, China's CSI 300 index closed up just under 3% over the week, helped by plans to increase allowed foreign ownership levels in Chinese financial companies. We have been keen on Chinese stocks for some months, and the CSI is now ahead by 24.2% for the year-to-date; the P/E ratio for the CSI 300 for 2018 stands at a still-moderate 13.7x earnings, with earnings growth forecast by Bloomberg at 14.6% for that year - therefore in excess of the prospective P/E - and estimate revision (the apparent direction of forecast changes) is positive, thus supporting valuation. Being about a quarter of the MSCI Asia-Pacific (ex-Japan) index, China helped that index close 0.63% higher over the week. **The performance of the MSCI Asia-Pacific (ex-Japan) index is a major success for the FAB Asset Allocation Committee's strategy, as it is the largest proportionate overweight position held - yet there appears to be much more potential for the medium-to-longer term, and certainly for 2018.**

"Overseas investors may yet see that opportunity to buy UK real estate assets very cheaply"

In bond markets, the Bloomberg Barclays Global-Aggregate Total Return (unhedged) index closed marginally ahead over the week, at 477.6617, and is up by 5.83% for the year-to-date. In US Treasuries, the yield on the 10-year rose by 6.6 basis points over the week, to 2.3984%, with the two-year yield increasing a further 4 basis points, to 1.6541%; this definition of the yield curve has been flattening steadily. We have observed in our Asset Allocation meetings that the yield on the policy-sensitive two-year looked out-of-kilter with expectations for perhaps three Fed rate hikes next year (i.e. that it looked too low). The yield on the 10-year Treasury continues to trade within its recent range, however; looking at our charts, a two-day close above 2.60% would begin to signal a definitive break to the upside (and about 2.16% to the downside, with the rising 377-day moving average currently at 2.10%). Rising shorter-term yields towards 'pain' levels historically signal the end of economic expansions, although we have few immediate concerns on this front, in what should continue to be an elongated and fairly healthy US economic cycle going into 2018. The fact that (especially in Asia-Pacific, as well as off a low level in the Eurozone) growth looks generally good is supportive of global equities – and although the US is still a heavyweight, it is becoming marginally less important in the global mix than it was. Aspects of last week's APEC meeting are covered in the Investment Summary, and are clearly relevant to one's updated view of the world. In Eurozone government bond markets, the yield on the German 10-year bund rose quite sharply, by 4 ½ basis points, to 0.4100%, seemingly as market players noted that the European Commission (EC) revised its growth forecast for the Euro-Area to 2.2% for the current year from its May figure of 1.7% (and which compares to the latest IMF forecast of 2.1%). Euro-Area growth forecasts of about 1.9% (the IMF's number) are beginning to look slightly too low. Viewed purely technically, a yield of 0.50% to the upside broadly equates to 2.60% on the US 10-year mentioned earlier. In foreign exchange markets last week, the dollar ended 0.58% lower on its index (DXY), at 94.391, a moderate move probably largely resulting from the sense that US tax reform may be delayed until 2018, with a (we think, small) chance that it may not happen at all. The euro was 0.49% stronger vs. the dollar (at $1.1665), and the dollar was 0.47% weaker against the yen (at 113.53). Even sterling strengthened by 0.91% vs. the dollar, although the increased possibility that any revised UK 'baseline' proposal regarding the financial separation will not be sufficient to allow trade talks to begin next month is weighing heavily on sterling - and added to all this is that over the weekend 40 members of her own party have declared 'no confidence' in Prime Minster May. **In summary here, the immediate outlook for Brexit and the tribulations of Mrs May have the look of a 'perfect storm', and - picking up a point from one of our recent reports - international real estate investors may in time get the opportunity to buy UK property relatively cheaply - but not yet.**

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“The political risk premium in oil has continued to advance”

In commodities, the price of international marker Brent crude closed the week 2.34% higher, at $63.52/barrel, with a wider spread (of $6.78) over West Texas Intermediate, which settled at $56.74/barrel for the near-month. The recent run in the price of Brent from the $51 level at the beginning of September to current levels (and reaching $64.65 mid-week) might ordinarily have provoked some profit-taking and corrective action, but these are not ordinary times; the advent of the recent political developments in Saudi Arabia and Lebanon (mentioned in last week’s report), plus concerns about region-wide relations will have led to an increase in oil’s political risk premium. While the latter cannot be quantified, we can broadly say that new bullish/ hedging sentiment has forestalled a sell-off. Despite recent better oil prices, there have continued to be negative impacts on credit ratings. Standard and Poor’s (S&P) lowered its long-term foreign and local currency sovereign credit rating on Oman to ‘BB’ from ‘BB+'', citing its dependence on the hydrocarbon sector despite efforts to diversify, and its rising debt load, although affirmed the outlook for the country as stable. S&P recently reduced Bahrain’s sovereign credit rating from stable to negative, while maintaining the rating of BB-, noting the deterioration of its net external asset position given historically low oil prices. However, in the case of Egypt, S&P revised its outlook to positive from stable, maintaining the ‘B-/B’ long- and short-term foreign and local currency sovereign ratings, reflecting the potential to raise the rating next year if structural reforms supporting investment, growth, and the reduction of inflation occurs. Elsewhere, in gold, the market absorbed reportedly large and specific selling out of the Middle East, although with spot closing the week about $5 to the good, at $1,275.07/oz. **There are large above-ground holdings of gold (and to an extent, silver) owned by Middle Eastern institutions, and their occasional need to sell can easily stop the market in its tracks.**

“The situation in Venezuelan sovereign debt is well worth following”

An interesting situation has evolved in Venezuelan government debt. President Maduro announced on the 2nd November that his country would “refinance and restructure” its future debt payments, and that that the $1.1 billion principal repayment on PDVSA 2017 bonds (which matured last week), would be paid. The head of a new government body formed to orchestrate the restructuring said the government would continue to meet its obligations on sovereign (and PDVSA, the state oil company) debt. Restrictions on US investors complicate matters. Up to this point, default on Venezuelan sovereign debt has been regarded more in terms of being a certainty, with its bonds priced accordingly. The restructuring involves some $105 billion equivalent in debt. Upon the announcement, government bond prices fell by about 50%, and the portents certainly didn’t look good. So what is President Maduro up to? Perhaps he engineered a huge sell-off to enable Russia and China to buy new bonds ridiculously cheaply? This was complicated by the fact that Maduro invited “Everyone involved in foreign debt” for talks in Caracas on the 13th November. Sanctions prevent US entities from buying any new debt issued by the Venezuelan government with maturities of longer than 30 days. The country cannot just cease to make payments, as the state oil company (PDVSA) holds substantial overseas assets, which could be at risk. PVSA will, it has been said, make the final $1.2 billion payment on a maturing bond. The sovereign bonds currently trade at 20-30 cents to the dollar, but of course this could widen still further. Venezuela has the world’s largest proven oil reserves, and as noted earlier, the oil price has been firm in recent months. Russian-controlled entities have already provided the country with about $17 billion in financing, so the provision of new, very cheap bonds to them could be the ‘thank you’. **With the PDVSA payment now tracked and in reality actually on the way, the CDS ‘Determinations Committee’ has deferred its judgment on CDS payouts to a meeting also scheduled to be held on the 13th November; CDS holders need a default ruling confirming the late payment to be able to close their positions. We will comment further as this interesting situation unfolds.**

“The APEC members have their own vision of their region – and Trump’s isn’t of import to them”

INVESTMENT SUMMARY:

- The broad passage and mood of Presidents’ Trump and Xi Jinping’s keynote speeches at APEC have parallels in the investment world
- Trump appears to have had a very cordial time in China, blaming previous Administrations for allowing huge trade deficits with China …and he did leave China with $250 billion or so in trade deals (some of which will stick), while inward FDI into the US will help offset trade
- Trump’s speech at APEC started well, with his compliments accurately chronicling the huge progress made throughout the region in recent decades …but participants lost interest when he got to the ‘America First’ part, which looked as though it was served up to look tough at home.
- President Xi Jinping, on the other hand, appeared masterful throughout, and countered Trump’s ‘Indo-Pacific’ vision with his own, by reference to his ‘*Belt and Road’ Initiative.*
- Trump’s comments sounded rather out of touch, in a region in which the *in situ* members will continue to trade more between themselves
- The US (or rather, President Trump’s) vision means little to them; as a small example, the Philippines used to be ideologically close to the US …but President Duterte has properly entered China’s sphere of influence – enjoying China’s investments, and growing tourist spending
- Readers will note that our Asia-Pacific (ex-Japan) equity overweighting is solidly thematic, rather than tactical …and last Thursday’s market action in Japanese stocks mentioned earlier suggests considering an overweight in Japanese equities
- If global geopolitical events (including in our region) begin to take a turn for the worst, the dollar may once again become a haven
- In developed equity markets, we are hoping for a short-term correction, as it would be a healthy development – although we wouldn’t sell now to buy-back later
- The FAB Asset Allocation Committee meets at the end of this week, and next week’s report will contain some of the discussion points
- Until then, investment policy remains unchanged

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