From West to East

Weekly Investment View
26th November, 2017

Gradual nature of new highs underline the momentum

The S&P500 index closed 0.91% higher over the week, edging to a further new all-time closing high, of 2,602.42, driven by technology, retailing, and energy stocks. The S&P is on a prospective P/E ratio of 17.71x for 2018, based on earnings growth of 10.0% for that year. Good Black Friday holiday sales were good (of course including online) for retailers and Amazon, while energy stocks responded to higher crude oil prices. Firmness in technology pushed the NASDAQ Composite index an impressive 1.57% higher over the week, to a new all-time high of 6,889.160, for a return of a fraction under 28% for the year-to-date. Technology stocks now account for approximately 34% of global equity free-float capitalization, and this helped the MSCI All Country World index move 1.32% higher last week. The STOXX Europe 600 index closed 0.74% higher over the week, and this might have been better had it not been for moderate euro strength - with Eurozone equities also reflecting hope by the end of the week that Germany's Social Democrats appeared to be seriously considering forming a new coalition with Angela Merkel after all. Continuing good Eurozone PMI data also helped sentiment, in a market inclined to respond to favourable economic news, and to expect that - come what may in terms of political horse-trading - the German political scene will stabilize. In Japan, the TOPIX index closed 0.95% higher, despite the yen firming against the dollar, a so-called 'bullish divergence' underlining positive sentiment towards equities. In Asia-Pacific, by mid-week Chinese equities had moved even further above their rising 144-day medium-term moving average (and on good volume), although during Thursday's trading that market proceeded to have a short, sharp shakeout; that day the Shanghai Shenzhen CSI 300 index fell by just under 3%, with a flat performance on Friday resulting in a 0.40% fall over the week, to 4,104.20. That index is now trading on a prospective P/E ratio of 13.69x for 2018, assuming 14.7% earnings growth. China is discussed in a subsequent paragraph. Hong Kong's Hang Seng index managed to close 2.29% higher over the week, while the Hang Seng China Enterprises index (comprised of Chinese companies quoted in Hong Kong) closed 2.58% higher. **Overall, and helped by the renminbi quoted just under 0.4% firmer against the dollar over the week, the MSCI Asia-Pacific (ex-Japan) index closed 1.65% higher, supported by technology and energy stocks.**

"The last FOMC minutes were slightly dovish, on balance"

In bond markets, the yield on the US 10-year Treasury edged very slightly lower, to 2.3418%, although the yield curve continued to flatten, given that the yield on the 2-year Treasury firmed by just more than two basis points, to 1.7443%. The yield on the German 10-year bund was almost static over the week, closing at 0.3600%. The minutes of the October FOMC monetary policy meeting, published last week, were deemed not to have changed the official US outlook for rates by much, with a rate rise next month fully discounted. There appeared to be concerns remaining regarding inflation not yet moving higher, although rebuilding the rate cushion via normalization appeared to be uppermost in FOMC members' minds. In foreign exchange markets, the dollar fell by 0.94% on its index, to close at 92.782, with the mix of factors including the FOMC minutes not being hawkish (the dollar immediately sold off), together with some US economic data (namely durable goods and consumer sentiment) that suggested slightly lower growth than had been assumed. Economic data out of the Eurozone - principally in the form of German's Ifo business climate index, which rose to 117.5 in November, from a revised 116.8 in October, and vs. Reuters expectations of 116.7 - on the other hand was favourable, with politics being overlooked. The euro firmed by 1.21%, to $1.1933. Cable closed similarly higher (by 0.92%, at $1.3337), with the currency seemingly ignoring reductions in official GDP growth forecasts in last week's UK Budget, and looking past the divorce 'price' concessions that the UK government are being blackmailed into giving to the European Commission - and whether British PMs will agree. Elsewhere, in commodities, Brent crude oil closed 1.82% higher, with WTI doing even better (up 4.24%), with the divergence between them largely resulting from a substantial outage on the Keystone pipeline into the US from Canada. Also in the US, the American Petroleum Institute reported inventories fell last week by 6.4 million barrels last week, confirmed the following day by the Energy Information Administration. In the background have been growing expectations that OPEC (and 'NOPEC') will agree to extent the current agreed production restraint at the meeting scheduled for the 30th November. **Lastly, gold closed just over $4 cheaper over the week, at $1,288.37/oz, a disappointing performance on the basis of what might have been expected given dollar weakness.**

"China and Asia-Pacific are an important theme in FAB's Investment Outlook 2018"

A recap on what is going on in China appears timely. In essence, the authorities there - and recently further emboldened by President Xi Jinping's strengthened position after the recent 19th Party Congress - are continuing with their self-imposed credit squeeze, as they try to do all they can to (a) reduce debt in the system, at all levels, (b) clamp down upon irresponsible wealth management products - and 'shadow banking', (c) bring about an economy driven by personal consumption, rather than industrial production, (d) to fight pollution in all its forms, and (e) to fight corruption. The list is in reality much longer, including the establishment of China's 'Belt and Road' Initiative (the new 'Silk Road'), and the furtherance of the renminbi as a reserve currency that major international counterparties will be happy to trade with and invest in. Last week, the immediate impetus for an equity correction (one had already been underway in China's sovereign and corporate bond markets) was the imposition of tighter online lending regulations, for instance causing online lenders' stock prices to move sharply lower. The authorities are serious about reducing leverage in the system, and preventing asset price bubbles (like real estate in Tier 1 and 2 cities). State-Owned-Enterprise debt has been carved-out, and is being addressed, and related surplus industrial capacity is being brought under control. The above is a gross over-simplification of what is underway, and there are no easy answers - and President Xi has been at pains to underline the challenges that China faces. In the face of all this, we believe Chinese equities have in recent months been on a sustainable upward path - and that with a few fits and starts (and provided the upside can be kept under control) good gains will accrue to investors over time. A longer explanation would detail the extent to which Chinese equities are grossly under-represented in global equity indices, and how this can be expected to gradually be rectified over time (and the same is true for bonds). Global investors have begun to smell the coffee, and are marshaling more resources to make sure this asset class is properly assessed. We have been bullish of Chinese equities for some months, although believe that most diversified global investment portfolios should have selected exposure. **The bears have been, and in our opinion are likely to continue to be, wrong.**

"Don't underestimate the power of dollar-cost averaging"

INVESTMENT SUMMARY: Market action in equities is looking slightly more normal, with less of a FOMO (Fear of Missing Out) overtone, and there is more rotational behaviour in sectors. A bit more volatility would be a healthy development. Strong corporate earnings growth has been helpful, and in tandem with improving global GDP growth. In, say, five years, global equity markets will probably be substantially higher, with emerging markets likely to be the best contributor to that (as well as providing much of the volatility, it has to be said!) - so the best plan of action for clients able to take at least a four/five year view is to apply 'dollar-cost averaging' out of reliable disposable income. Investing the same amount of money in the right instrument(s) each month should enable large amounts of capital to be accumulated over time. More units are bought when prices are low, and fewer are bought when prices are high. This concept is mathematically powerful, and that is before the benefits of compound interest on dividends. Investors will actually want to see the markets move lower (at least in the intermediate term), and can therefore be relaxed about short-term market movements. Clients can still take trading decisions in the 'satellite' portion of diversified portfolios (the hedge fund fraternity call this a 'side pocket'), concentrating in areas where they are most likely to be able to add 'alpha' (i.e. outperformance over-and-above a benchmark). ETFs can be used to build capital over time, with such funds usually enjoying very low management charges - while more specific - and slightly above average risk investments - can be traded at the edge, and on the understanding that in such cases one should usually run profits, and cut losses, despite the latter often being very difficult to do. **Pending the next Asset Allocation Committee meeting, investment strategy remains unchanged.**

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