From West to East

Weekly Investment View

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Global leaders confront their challenges – while risk assets advance

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The S&P500 closed at yet another new all-time high at the end of last week (for the 39th time this year), at 2,519.36, an increase on the week of 0.68%, making the gain for the year-to-date 12.53%. This is despite a 70% market-derived probability of a Fed rate increase in December, and probably a further three hikes next year. The continued climb of the so-called 'Wall of Worry' was confirmed by new all-time highs in the NASDAQ Composite index, and small-and-mid cap stocks. Technology stocks once again did well (with Cisco Systems in the vanguard), with the IT segment of the S&P500 now up by 27.4% for the year-to-date. European stocks as measured by the STOXX 600 index rose by 1.31%, following the technical victory of Angela Merkel in last week's German Federal elections, and despite the proposed Catalonia independence vote this weekend. The US dollar saw more stability last week, with an intermediate recovery in the offing, after an increase of 0.98% on its index. The euro/dollar rate fell by 1.15% over the week, a function of the dollar strength mentioned, plus the understanding that the Eurozone still has some political obstacles ahead. US Treasury yields rose over the week, but remain in the broad sideways trading range (on the 10-year) seen for most of this year. US 'core' inflation on the Fed's favoured PCE measure came in lower than the Fed would have liked, at 1.3% year-on-year, yet this time there is the real sense – notwithstanding a major adverse market event – that rate 'normalization' will now occur, to rebuild the ability to reduce rates at some time whenever necessary in the future. In oil markets, the price of Brent remained relatively up-beat over the week as a whole, being ahead by 1.20% (at $57.50/barrel), probably more than anything reflecting Turkey's threat to cut off Kurdish oil exports (production is of the order of 400,000 barrels/day). WTI did better, rising by 1.99% over the week. **Gold closed at $1,279.75/oz, down about $15 over the week, and back below the important $1,300 level as risk assets elsewhere in the markets continued to climb the wall of worry.**

"Merkel wins, but the sense is that it was a hollow victory"

Early last week, Angela Merkel and her Christian Democrat (CDU) party were victorious in the German Federal elections, but by the narrowest of margins – a result that was, frankly, less than impressive. The CDU won with 32.9% of the vote, the Social Democrats took 20.5%, and the far-right 'Alternative for Germany' (AfG) an impressive 12.6%. The start to Merkel's fourth term as German Chancellor could involve a three-way coalition including the Free Democrats and the Greens, who garnered 10% and 9% of the vote respectively. The results prompted a swift sell off in the euro that started the week around 1.2000 to the US dollar, and finished at 1.1814. Fears that any coalition pact reflecting divergent views that could stymie progress in Europe's largest economy took hold of markets. On Wednesday, Angela Merkel was back on the stage again, campaigning for another upcoming vote, for the state of Lower Saxony. The CDU candidate there, Bernd Althusmann, is up against the state's incumbent premier, Stephen Weil of the Social Democrats (SDP). The vote takes place on the 15th October. Support for Althusmann has been falling of late; according to opinion polls his approval rating has dropped to 24%, while the CDU party as a whole is forecast to win 37% of the vote, which would fall short of earlier expectations and be a further test for Angela Merkel soon after the Federal elections. While these European results are collectively not as bad as some had feared at the end of last yetar, many fear that Austria's vote (also on 15th October) could upset things, as we suggested last week. Elsewhere, the Italians have until next year to cast their vote with the populist 'Five Star' party very much in the frame. As these events begin to unfold, in the background markets are still looking for a 'taper timetable' to Europe's easy money polices, and an eventual rise in interest rates. Speeches and comments from Mario Draghi will be watched over the weeks and months. **We remain overweight in European equities despite this backdrop, where valuations still look attractive compared to many other developed markets.**

"Trump unveils revolutionary tax cut proposal while still seeking to repeal healthcare"

Last Wednesday, US President Donald Trump presented his tax reform proposals, which he

described as "The biggest tax cut in the history of the country". The proposals aim to cut the overall tax burden in the world's largest economy by about $5.8 trillion. This would include a cut in corporation tax from the current 35%, to 20%, giving US corporations more leeway toward 'Making America Great Again'. His agenda includes cuts in income tax for American families, while simplifying a very antiquated tax code system in the country. The US currently has seven tiered tax scale levels, from 10% to 39.6%. Trump proposes to reduce these to just three scales, i.e. 12%, 25% and 35%. He left it to Congress to decide what taxes the richest Americans would have to pay, above the 35% category. In his address in Indiana, Trump said the reforms would create jobs for people and bring back wealth that had left the country. The reform of the tax system is the single most important pre-election manifesto pledge he and the Republican Party are seeking to implement. White House economic advisor, Gary Cohn, echoed that "This was a great deal". He stated that the Republicans "were in a good place" to get the votes needed in Congress to push the proposals through. Many have questioned how the Trump Administration proposes to pay for such ambitious reform. **Cohn answered the critics, saying US growth would exceed 3% as a result of the deregulation, which would cover the initial shortfall.**

"The case for a rebound in the dollar is growing"

The US tax reform proposals come after a very trying period for Trump's presidency, as he continues to seek to repeal the US healthcare system known as 'Obamacare', which has eluded him since he became president, after the proposal was shot down in Congress earlier in the spring. Overall, markets took the tax cut proposals positively with the dollar index (DXY) strengthening close to the 94 level after being in the doldrums most of the summer. Risk sentiment improved in the week, with US Treasuries (a barometer of risk) selling off aggressively. The 10-year US Treasury yield has swung back upwards, currently trading at 2.33%, back into our beginning of the year forecast range for the 10-year yield of between 2.30%-2.60%. The tax proposals, along with a more hawkish statement earlier last week by Fed Chair Janet Yellen on the path for US interest rates and the Federal Reserve's timetable being announced on the tapering of its USD $4.5 trillion balance sheet, leads us to expect a new round of dollar strength. This would follow disappointment so far this year at Trump's lack of execution in Republican policies, along with the Federal Reserve being perceived until quite recently as quite dovish on the rolling-back of accommodative monetary policy. US data releases last week included a positive Q2 US GDP revision, that came in at 3.1% (vs. the initial 3.0% estimate), and continuing jobless claims showing the longer-term unemployed in the US has fallen to 1.934 million, vs. the 1.993 million expected. **The Asset Allocation Committee of FAB remains positive on the US dollar for the long term. In Fixed Income, we remain tactically pro- High Yield, while being underweight in Investment Grade, the latter of which has played out quite nicely with the recent increase in US Treasury yields.**

"'Make America Great Again' - Bombardier bombarded"

As an example of what can happen in the new Trump world of trade, Canadian aircraft maker Bombardier had a ruling against them in the US courts in an action brought by American plane maker, Boeing. In that ruling, Boeing alleged the Canadian government was providing unfair subsidies to Bombardier. The allegation was denied by the company. Trump's Administration applied a 220% import tariff on Bombardier, which not only has implications for Bombardier, but also for the UK, where Bombardier employs 4,000 staff at its Northern Ireland plant making aircraft wings. British Prime Minister, Theresa May, hit out by saying that this was "bitterly disappointing news", and suggested that the UK's relationship with Boeing could be negatively impacted, after lobbying the Trump Administration over the issue prior to the announcement. **This now raises serious questions about the US/UK trading relationship in a post-Brexit world, and more importantly what will be the implications for other firms that potentially challenge US rivals in trade in such a manner.**

"The 'Goldilocks' environment for risk assets remains in place"

INVESTMENT SUMMARY: The FAB Asset Allocation Committee is scheduled to meet later this week, and pending this, investment policy remains unchanged. Global equities appear to be in a solid and consistent upward trend, fuelled by renewed optimism on US tax reform, global growth statistics that continue to improve, and net-positive political developments. In global equities, we have stayed overweight, and in terms of sectors, in Financials, with a Healthcare overweight as a 'bar-bell' balancing strategy. In recent months we have stuck to the line that US tax reform is still likely to happen. **Meanwhile, higher interest rates can be tolerated, provided Fed funds doesn't exceed about 4%, and US GDP growth is 3% or slightly better. In global fixed income, investors still need some yield in balanced portfolios, so those asset classes are firmly in neutral, especially while global growth is not massively exceeding the 3% level.**

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