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FAB
First Abu Dhabi Bank

From West to East

Weekly Investment View
9th October, 2017

The Trump Trade is back

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Commentators have been saying that Friday's September US non-farm payrolls were meaningless because of the hurricanes, and overall that is correct. The data came in at a fall of 33,000 (vs. an estimated range quoted by the FT of a 45,000 fall, to a 150,000 increase), but this included a surprise uptick in manufacturing jobs. Average hourly earnings rose 0.5% in September, for a year-on-year change of 2.9%, and these too will have been affected by divergent demands for workers in different sectors. Interestingly, though, the previous two months wages numbers were revised upwards, including August now being up 2.7% year-on-year, vs. up 2.5% previously. So although the hurricanes distorted September's data, the revisions for prior months suggests good underlying growth, with a chance that wage growth has genuinely begun to quicken. Initial claims for state unemployment benefits dropped 12,000 to a seasonally adjusted 260,000 for the week ended 30th September, coming in better than expectations. In other developments, the US House of Representatives passed a $ 4.1 trillion budget resolution comprised of an increase in defence spending, as well as more relief to the hurricane-affected states, out of which could come a growth story for infrastructure and basic materials. The achievement of the budget resolution is likely to be an important lead-in to the Trump Administration's proposed tax overhaul. Other US data was very supportive, including the latest 'core' durable goods, and especially the ISM Services PMI for last month. As a result of all the above, the usual Bloomberg market-derived probability of a rate increase this December stood at 78.5% at Friday's close, up from 70.0% at the end of the previous week, with the CME Group measure reportedly showing an even higher probability of a hike. **Accordingly, unless something extraordinary happens between now and the FOMC meeting on the 13th December, we will be assuming a 25 basis point increase in the Fed funds rate in all the articles planned for our upcoming FAB Global Investment Outlook 2018, and we are currently assuming a further three rate increases in 2018.**

"Sterling suffers from the UK political sit-com"

The S&P500 closed 1.19% higher over the week (at 2,549.33), and is now 13.87% ahead for the year-to-date, led by Technology (up 29.3% for the S&P sector), followed by Healthcare and Basic Materials, with Energy, Telecommunications and Consumer Staples lagging the most. US equities closed down slightly on Friday, after a string of eight 'up days', as Energy stocks came off, reflecting correcting oil prices. The Stoxx European 600 index closed up 0.34% over the week, mainly held back by Spanish stocks (which fell by 1.9%) following the previous weekend's Catalonia independence vote. Japan's TOPIX index rose by 0.74%. The MSCI Asia Pacific ex-Japan index rose 1.73% during the week, despite Chinese markets being closed for a holiday all week. In developed FX markets, the most notable change was a fall of 2.48% in cable (to $1.3066), mainly driven by continued speculation that Theresa May's days as British Prime Minister could be numbered, and that this would further complicate the achievement of an orderly and fair Brexit. For those of our readers who saw it, you would probably agree that the altogether unfortunate mishaps during the PM's keynote speech at the annual Conservative Party conference last week amounted to an excruciatingly awkward interlude for Mrs. May. While most of it was bad luck, irrespective of that it all made her look powerless and lacking authority. **There were suggestions over the weekend of a cabinet reshuffle being called by Mrs. May, in which her troublesome Foreign Secretary, Boris Johnson – who recently set out his own recommendations for Brexit - could well be demoted.**

"The ECB is determined to win the currency depreciation war"

The dollar index was 0.78% firmer over the week (at 93.800), having been higher than this immediately after the non-farm payrolls. The increasingly stable tone of recent weeks continued, essentially as the sense that the Trump Administration's plans might at least in part come to pass gained credence. The euro/dollar mirrored the dollar index, being 0.71% lower over the week (at $1.1730), while the dollar/yen pair closed only slightly firmer at ¥112.65. The minutes of the recent ECB policy meeting were interpreted by some as suggesting that the central bank will not be in any great hurry to normalize rates - consistent with our thesis that the ECB will in reality deliberately lag the Fed's actions in this regard so as to win the currency depreciation war - quite apart from the fact that the central banks cannot all reverse their QEs at the same time; they all talk to each other, and an orderly queue and amounts will surely be arrived at. In fixed income, the 10-year US Treasury yield firmed by two and a half basis points (to 2.3589%), was left sitting almost exactly in the middle of the trading range going back some months, after spiking to above 2.40% following the NFP data. The more policy-sensitive US 2-year Treasury yield was just over two basis points higher over the week, at 1.5040%, indicating that the markets are not as certain as the Fed is that up to three more rate hikes should be expected next year, following the one almost fully discounted for this December. The yield on the German 10-year Bund was half a basis point lower, at 0.4590%. **The Barclays Global Aggregate Bond index (in dollars, unhedged) fell by 0.50% over the week; our basic technical analysis of this major benchmark suggests the multi-decade global bull market in bonds has not yet ended.**

"Base metals renewed their uptrend"

In commodities, and turning to crude oil, Brent was 3.34% lower over the week (at $55.62/barrel), despite it becoming apparent that the Saudis and Russians look as though they will agree to an extension (perhaps to the end of next year) of last November's agreement on production restraint. As we write, storm Nate had begun to disrupt oil production along the US Gulf coast. The Saudis and Russians (meeting in Moscow this week) are of the opinion that improving global oil demand will more than offset further US shale oil production, which has continued to increase to just above 6 million barrels/day. The two sides agreed energy deals totaling $3.4 billion, including MOUs covering oil pricing and services agreements. Of course there are numerous factors impacting oil markets, and as an arbiter we regularly resort to our favoured technical analysis, which suggests that $65 for Brent still looks possible sometime in early 2018. Again, we will be writing on this in the Outlook. In base metals, the London Metal Exchange index rose 2.34% last week, to 3,124.70, in a renewed uptrend, and likely consistent with the perception of a generally improving outlook for risk assets, including for those of a 'late-cycle' nature. We usually end this section with gold, which fell by 0.24% (to $1,276.68/oz, after a low of close to $1,260), and rose slightly in euro terms. **We would note that it was Golden Week in China last week, and that Chinese gold off-take was noticeable by its absence; the important resistance level to watch remains $1,300, a break of which would likely be significant for traders.**

"Following Catalonian events will be key this week"

After last week's vote on independence in Catalonia, it remains to be seen exactly what happens next regarding this issue. The Catalonian parliament was due to discuss the way forward this Monday, but Spain's government (via the Constitutional Court) has suspended that planned session, which if effective impedes further discussion in the short-term. A unilateral declaration of independence may still occur, irrespective of its legality, although it is to be hoped that cool heads will prevail - but they may not. Like many investors we are doing a refresher course in Catalonia, and the Spanish constitution. The Catalan Socialist Party is against secession from Spain, and it is they who initiated the action to block the planned meeting of regional MPs. The EU has called for calm. Investors have naturally been concerned by the possibility that all this could result in a Spanish constitutional crisis, and in a wider bloc which has perhaps seen more than its fair share of political turmoil (with some economic crises) in the last few years. The Catalonian region has an economy "roughly the size of Portugal", according to the FT, and "accounts for about 19% of Spanish GDP", equivalent to about €212 billion, which is "higher than most Eurozone countries". The recent recovery in the Spanish economy - which after recent difficult years has been very welcome indeed - could be stopped in its tracks if the situation gets out of hand. Spanish (and of course Catalan regional government debt) yields have risen; last week the yield on Spanish 10-year government debt reached 1.71%, up from 1.43% in early August. In the back of investors' minds is that this is a situation that has been a 'slow burn' for many years. Spanish bank stocks suffered disproportionately last week, as one would have expected, and they may continue to do so if Spain's credit ratings end up suffering, with potential ripple effects for banks using Spanish bonds to back ECB (or other) funding. On the positive side, the FT quotes data from the Madrid Stock Exchange to the effect that for last year only 36% of Ibex (Spanish stock index) revenues were actually generated out of Spain itself (vs. as much as 76% in 1997). Spain accounts for about 4.95% of the STOXX 600 index. We will be watching events as they unfold very closely. **The FAB Asset Allocation Committee position remains 'overweight' in European equities.**

"Catalonian developments inspired secessionists – in Brazil"

An interesting story in the FT described how what is happening in Catalonia has apparently motivated secessionists in the southern Brazilian states of Rio Grande do Sul, Santa Catarina, and Paraná to quickly move forward with a referendum over this weekend. This could be quite a significant development, with the 'The South is my Country' movement looking to form a new country of 29 million people, said the FT. This is a relatively prosperous part of Brazil, and it is seen to be paying for waste and poor decision-making in Brasília. Again, this situation has been a very slow burn, but it does seem that current events in Catalonia could have indeed provided a meaningful catalyst for these southern Brazilian states to go for independence at this time. **Of course analysts doubt that anything will result in practice, although we will follow-up this story (and any others like it), which seem set to challenge the status quo of selected nation states, and be increasingly important to investment outlooks as what can be called 'nationalist disruptors'.**

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"Chinese equities should open better after the Golden Week absence"

INVESTMENT SUMMARY: We keep reading that global economic growth is relatively synchronized, and while this appears to be true in terms of the majority of constituents, it should not be forgotten that China is probably sporting 6-7% in annualized growth despite imbalances, augmented by the quickly-developing set of countries around it. Even if the real number is closer to 5%, that would still be excellent. The majority of emerging economies in the Asia-Pacific region (and for our purposes, including India) are stronger and more capable of coping with higher interest rates in the US (and a possible rebound in the dollar) than they were at the time of 2013's 'taper tantrum'. While in no way forsaking the developed world's markets, our regional investment emphasis is on the Asia-Pacific region going into 2018. **In the very short-term we should see the Chinese markets open higher following their absence during Golden Week.**

"The Asset Allocation Committee remains tactically overweight in US equities"

In the US, Mr Randal Quarles has been confirmed by the US Senate as the Federal Reserve's incoming vice-chairman of supervision, a gentleman who can be expected to ease regulations. The latter - along with fiscal expenditures and tax reductions - are likely to be instrumental in creating a better business environment in the immediate years to come in the US, and this is one reason why we have remained with an overweight recommendation in Financials. It is not simply about the endowment effect from higher interest rates. In terms of sectoral and style exposures, it may now be more appropriate to emphasize 'value', rather than 'growth'. Regarding investment policy, our FAB Asset Allocation Committee (AAC) met late last week, and no immediate changes to strategy were made. **However our readers should be aware that the AAC exists to be 'tactical', and that its members are not simply watching US equities drift upwards to recurrent new highs (with investors benefitting from that overweight position) in the belief that 'trees grow to the sky'. By experience, they do not, and one of the ways of maximizing returns is effective diversification into asset classes whose appreciation potential is thought to be superior.**

"S&P500 estimates are once again improving, supporting the asset class"

As we go to print there is a growing expectation that Korea may test a missile with the ability to reach California. As always, bad things can happen, and we are not trying to spoil the party. However, looking at things that we reasonable do know, there is also a growing probability that for the immediate future, many of the investment metrics that we follow are flashing 'positive', and confounding the equity bears. The US dollar is now showing more stability, helped (for instance) by the apparent lack of appetite on the part of hedge fund managers to increase their long-euro bets. Although noting the continuing negatives of possible changes to NAFTA, lingering adverse geopolitics - and at times, President Trump himself - the AAC is also aware that earnings estimates on the S&P500 are once again inching ahead, and that a P/E ratio of 17.5x for next year may not be expensive after all. **Under these circumstances it is consistent to remain overweight in high yield bonds, especially as default rates are low.**

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