From West to East
Weekly Investment View
22nd October, 2017

Still expecting an equity correction - despite an improving outlook for US tax reform

Almost certainly the most important news of the week was that the US Senate agreed a Republican $1.5 trillion budget resolution for next year, by 51 to 49 votes, with only one Republican vote against. This clears the way for the Trump Administration's planned tax reforms. This Senate version is based upon up to $1.5 trillion of tax cuts, while the current House of Representatives form embodies more of a deficit-neutral tax framework, so the next step is to bring these more in line with each other. The markets, which had in any case been climbing a proverbial 'wall of worry', were encouraged by the result of the vote. Accordingly, fresh new all-time closing highs were achieved by the main US equity indices, including the S&P500 and NASDAQ Composite up by 0.86% and 0.35% respectively over the week. The S&P500 has now been up for six weeks in a row, with the S&P Information Technology sector leading (+3.9%) for the month-to-date, and for the year-to-date (+32.3%). It was interesting to hear Steve Mnuchin, US Treasury Secretary, caution earlier in the week that stocks could reverse a "significant amount" of their recent gains if Congress failed to proceed with tax reform, and on the back of last week's vote not going the right way. **In saying this, Mr Mnuchin instantly crystalized the worries of many market participants, while warning Congress that they had the power to wreck the recent positive net worth effect of rising stock prices – and in reality asked them whether they really wanted to do so.**

"A 'melt-up' in stocks could have been delayed, helped by the likes of Apple and General Electric"

We have remained on board the US equity locomotive with an overweight position, although aware that market leadership has in reality been quite narrow. There have been a few tentative signs of a possible short-term peak, despite the third quarter results season in the US having started well. During the week there was volatility in technology stocks, especially the market darling, Apple, as commentators worried about indications that sales for its latest iPhone haven't been very good, and we also note the extremely choppy price action in General Electric, after dreadful results and guidance. In the latter, investors bought the 6.3% dip after acknowledgement by new top management that the results had indeed been completely unacceptable – but what if they don't succeed in fixing the aerospace division (most old hands know that the majority of corporate turnarounds fail to occur). **Elsewhere, IBM stock did very well last week after good results and signs that top-line growth is resuming after a five-year pause.**

"Mr Abe should win today's Japanese general election – but could it be a 'sell the news' story?"

In other equity markets, the STOXX European 600 index closed fractionally lower, held back by lingering concern regarding the Catalonia situation, with the upshot there being that the Spanish central government has announced its intention to suspend the local government and organize new elections in about six months. Realizing the imminent threat, and probably feeling less and less capable of carrying the day, the regional Catalonian president had not made any definite announcement about secession from Spain. Moderate downside in Spanish equities last week led to a 0.33% fall in the STOXX Europe 600 index. In Japan, the TOPIX rose by 1.29% (to 1,730.64), to within a few percent of its 2007 high, sustained by yen weakness vs. the dollar as well as it becoming increasingly clear that Mr Abe will be returned as Prime Minister in today's general election. There has been no effective political opposition. Many in the market expect a 'sell the news' correction in the short-term upon confirmation of Mr Abe's win. **We intend to write up the outlook for Japan and its markets in next week's report.**

"President Xi's handling of the 19th Communist Party Congress appears to have gone according to plan"

In Chinese equities, the CSI 300 index closed 0.15% firmer over the week, holding steady during the 19th Communist Party Congress, in which President Xi Jinping consolidated his position for at least the next five years – and possibly longer. President Xi promised further reforms, the continuation of a crackdown on corruption, and an apparently serious intention to fight pollution. A day before President Xi's opening speech, official confirmation of 6.8% annualized growth in the third quarter set the scene for what was to be an almost four hour speech. **Probably about the only obvious negative to emerge from the proceedings was renewed concern about Chinese debt levels, fuelled by cautionary remarks from the Governor of the People's Bank of China, the central bank.**

"Some commentators are questioning the extent to which Catalonia really wanted to separate"

Turning to bonds and foreign exchange markets last week, global bonds sold off by 0.67% as measured by the Bloomberg Barclays Global-Aggregate Bond index (unhedged currency), consistent with the yield on the US 10-year Treasury rising by just over 11 basis points, to 2.3845%. The yield on the policy-sensitive US two-year Treasury rose by just over eight basis points, to

1.5763%, as the markets began to more fully take on board that more reflation than earlier expected was on the cards after the Senate budget deal, with therefore renewed concern about a higher fiscal deficit, as well as the chance that the out-turn for US inflation could be higher. Having said that, US 5-year 'breakeven' (market-derived inflation expectations) were only fractionally higher over the week, at 1.78%, so the market still appears not to believe that inflation is set to increase by very much. As the usual Fed funds futures measurement now suggests, there is a 83.6% probability of the Fed funds rate being raised by 25 basis points in December (up from 73.3% at the end of the previous week), so we reiterate that this is taken to be a done deal – indeed the markets would be shocked if it doesn't happen; the markets have 'signed it off'. So the dollar rose by 0.66% on its index (DXY), and was especially strong against the yen. **The fall in the euro vs. the dollar was only 0.30% (to $1.1784), likely softened by reduced tension from the Catalonia situation.**

"Another 'buy quality UK real assets with historically cheap sterling' opportunity may await investors from this region"

Sterling weakened by 0.72% (to $1.3190) as calmer diplomatic statements regarding the course of Brexit from UK Prime Minister, Theresa May, and European Union officials failed to convince markets that the outlook for this was anything other than bleak; the UK Chancellor of the Exchequer is finalizing contingency plans for a 'no deal' Brexit, and maybe not entirely as a negotiating ploy. For the time being it is difficult to see the pressure coming off sterling, and in addition because the Bank of England's Deputy Governor, Jon Cunliffe, said last week that it wasn't clear to him that interest rates needed to rise soon. **Something we are seriously reviewing is the re-emergence of the possibility of being able to buy quality/trophy UK real estate assets on a depressed basis sometime during the next 12 months or so – with a continuing softness in underlying asking prices (clearly thinking of residential) being augmented for foreign buyers by sterling downside.**

"The price of Brent crude firmed last week, when some weakness might have been expected"

In oil markets, the price of Brent crude, the international marker, rose by 1.45% during the week (to $57.75/barrel), with the premium over West Texas widening back out to just below the $6 level, vs. a more historically normal spread of $1-3. Market players had known that any real disruption of Kurdish oil production would affect the markets, at least at the margin. As far as we can tell, relative calm has been restored, although with a rather different result to the one President Barzani of Kurdistan would have hoped for after the results of the vote to secede from Iraq a month ago. It is impossible to identify and calibrate the myriad factors that combine to result in global oil prices at any given time, yet collectively we would reiterate that improved global demand appears to rely on being met by collectively many still quite unstable sources of supply. Last week the EIA (US Energy Information Administration) reported a fourth successive weekly drop in crude stocks, partly offset in sentiment terms by the news that gasoline inventories had risen by more than expected. The bottom-line in oil for us is that our confidence in seeing $65 in Brent sometime in the first quarter of 2018 continues to grow. **Turning to gold, this closed back below the significant $1,300 level, at $1,280.47, down from $1,303.82 a week ago, reflecting moderate dollar strength, the overall continuation of a 'risk-on' tone in many risk assets, and the lack of any significant deterioration in the geopolitical climate.**

"Emerging market equity bears are finally giving up, and covering shorts"

INVESTMENT SUMMARY:

- **A bullish stance on equities has been vindicated so far this year - the bears are giving up, certainly in Emerging Markets**
- **The previous week's upwards revisions in growth by the IMF makes our point; these are driven by Europe and Asia-Pacific**
- **Bonds continue to provide worthwhile diversification in diversified conservative portfolios**
- **The probability of a December US rate hike has increased to 83.6% - hence is discounted**
- **We currently advise staying neutral in Technology, and overweight in Financials and Healthcare**
- **It could now be correct to move overweight in Energy (oil price view below) - and as a 'value' play?**
- **The Asia-Pacific (ex-Japan) overweight is working well - and we will review whether it should now include Japan**
- **Indian equities have been excellent for us this year - investors are looking through the GST wobble**
- **In oil, last time we suggested $60+ was in sight for early 2018; we now expect $65**
- **In local markets, UAE equities could play catch-up - but KSA faces some challenges**
- **We advocate remaining overweight in equities, hoping for a correction to selectively add**
- **The US dollar looks quite stable; we expect US tax reform in 2018; Congress must deliver good news**
- **Markets are discounting about three more rate hikes in the next two years, which looks too low**

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