From West to East

Weekly Investment View
30th October, 2017

Can the market avoid a 'melt-up'?

Major events in the markets last week included the following: excellent results 'beats' from Amazon, Alphabet (Google), Intel and Microsoft, driving Information Technology and related stocks higher; the announcement of a 'dovish taper' from the ECB, leading to weakness in the euro; the initial estimate of US third quarter GDP came in at 3% annualized, exceeding forecasts of about 2.5%; and lastly, the regional political leaders in Catalonia declared independence from Spain, coincident with the latter's central government saying it was taking control and calling new elections for early December. In the US, the NASDAQ Composite index closed up 1.09% over the week, with the S&P500 0.22% ahead, both indices closing at new all-time closing highs. The S&P and NASDAQ are up by 15.29% and 24.49% respectively for the year-to-date. The S&P500 has gone almost a year without a correction of 5%, with the FT reminding us this hasn't occurred since 1928. We have been looking for an equity correction in US equities for the last six months or so, within the context of providing a further buying opportunity in risk assets, and also for stocks to have a 'pause that would refresh'. In the same way we would rather equities avoid a 'melt-up', market action driven by investors correcting underweight positions (or the fear of missing out), and/or by short -covering. The stance of the FAB Asset Allocation Committee has been overweight in global equities for the year-to-date (led by the US, in Eurozone equities (ex- the UK), and also specifically India within global emerging market equities). However the Committee reduced the technology overweight to neutral too early. **Looking at Information Technology within the S&P sectors, this is ahead by 36.1% for the year-to-date, followed by Healthcare (at 20.8%).**

"At this point, the US economy is already doing fine – before the advent of tax reform"

The STOXX Europe 600 index rose by 0.85% over the week (to 393.43), helped by euro weakness (down by 1.49% vs. the dollar, to $1.1608), although held back at the margin by weakness in Spanish stocks as the Catalonia situation became tense towards the end of the week. Mario Draghi, President of the European Central Bank delivered confirmation of a 'dovish taper' following the ECB's monetary policy meeting that concluded last Thursday. Essentially, they will continue the current rate of bond purchases (€60 billion/month) until year-end, and thereafter halve this to €30/month until at least next September, although as yet with no stated end date. The point was explicitly made that today's ultra-low interest rates (the ECB's refinancing rate remains at zero) would stay low until way past the ultimate end of its QE. Given these official comments the yield on the German 10-year bund closed the week down by almost seven basis points, at 0.3830%. Elsewhere, in foreign exchange, Cable traded just under half a percent lower over the week, to $1.3128 (with it now less clear that the Bank of England will raise rates after all), while the yen fell fractionally against the dollar (to 113.67). So being mainly euro weakness-led, the dollar closed 1.30% ahead over the week on its index, at 94.916. The dollar was also gently supported by a growing sense in the markets that US tax reform was becoming more probable, although with the end result still subject to the exact number of prospective votes in favour, as one or two Republicans not falling in line could still affect its successful passage. In bond markets, the key yield on the US 10-year Treasury edged ahead by just over a basis point (to 2.4064%), as did the yield on the US two-year Treasury (to 1.5875%). The usual Bloomberg Fed funds futures-derived probability of a December US Fed rate rise rose a bit further, to 85.3% (from 83.6% the previous week), so it is virtually fully discounted. The fact that the initial estimate of US third quarter growth came in at a healthy-looking 3.0% (and the previous quarter was revised slightly upwards to 3.1%) might have had a larger upward effect on US yields had it not been for the dovishness of the ECB policy message; so at the margin the US financial authorities will have to try that bit harder (via less dollar rate upside) to prevent the US dollar rising vs. its peers to avoid giving back recently won export price competitiveness. Under these circumstances - i.e. with about 3% annualized US real economic growth - this is a good level of growth for investors to be going along with, and perhaps almost defines the 'not too hot' side of the 'not too hot, not too cold' measuring stick of what is best for markets, in which growth avoids over-exuberance on the one hand, while continuing to show gradual recovery on the other. **Certainly in this sense, Goldilocks is alive and well – and this is before the benefit of US tax reform, the easing of the regulatory environment, or extra infrastructure spending.**

"The size of the Indian state bank refinancing far exceeded all expectations"

A fairly significant event took place in India half way through last week, in that the country's Finance Ministry announced its intention to inject the equivalent of just over $32 billion into the state-owned banks during the next two years. Individual bank stocks shot up by between 20-30%, as the amount of the bailout was a multiple of what had already been promised, demonstrating that the authorities are really serious about recapitalizing the sector, which has been suffering from a significant legacy of bad loans, often linked to sectors such as steel and infrastructure. Gross non-performing loans at the state-owned banks had risen to 13.7% of their assets as at the end of June this year, up from 5.4% in March, 2015. It is well known that despite the (in the main very sound, we think) logic of demonetization and rolling-out a nationwide General Sales Tax, there has been extra short-term hardship and economic dislocation resulting from them. Lending growth from the sector had been deemed insufficient to fuel sustained economic growth prior to demonetization, and since then the public banking sector has been losing market share to the privately-owned lenders, with some of the latter looking very full in terms of valuation. Unsurprisingly, investors haven't been very keen to invest in the state-owned banking sector, and there has been concern that much of the liquidity that they possess has tended to be parked in the bond market, rather than fuelling lending. Cynics will say that other linked measures will be necessary to make sure that a good portion of the new capital to be allocated finds its way to finance good quality lending. It is known that this cannot be the end of the refinancing story of these banks, given the need to meet Basel III requirements by 2019, and in a sector that is far less well capitalized than its privately-owned peers. Fortunately, India's finances are in quite good shape, so the rupee has remained stable throughout this latest episode, closing at 65.05 to the US dollar last week. As we write, the SENSEX index (which was up a further 2.37% last week, to a new all-time closing high) is trading at 21.6x earnings for the current fiscal year ending 31st March, 2018, assuming consensus earnings growth of 12.8%. The market P/E falls to 17.2x for the 2018/19 fiscal year, based on earnings growth accelerating to 25.7%. For the following year (fiscal 2019/20), the forecast P/E is 14.9x, based on earnings growth moderating to a more 'normal' 15.3%. **We remain keen on Indian equities and structurally overweight within the emerging market equity basket; the Modi government appears to have made another good, pro-growth decision, provided some new checks and balances are introduced to assist this move.**

"We hope any equity 'melt-up' will be much delayed"

INVESTMENT SUMMARY:

ECONOMICS & POLITICS:

- Last week's Q3 US GDP growth number was the first back-to-back growth above 3% since 2014
- …and this could lay the foundations for good non-farm payrolls in the immediate months to come
- University of Michigan US consumer sentiment improved by less than initially estimated for October (i.e. 101.1, vs. 95.1 in September) but is still very healthy
- The Euro-Area Flash Composite PMI fell 0.8 points (to 55.9) in October, but this is still a good number, signaling good growth
- Although they would never explicitly say so, the ECB wants to keep the euro as low as possible for as long as possible
- …and last week's 'dovish ECB taper' is entirely consistent with this; we retain a partial euro hedge on European equity positions
- China's industrial profit growth accelerated further in September (up 27.7% year-on-year in September), helping to sustain growth
- The background to the Catalonia situation was discussed in detail a few weeks ago, and we are relatively unconcerned by recent developments
- Mr Abe's win in the recent Japanese general election with a 'super majority' helps keep that equity market a 'strong hold'/neutral
- After their Party Congress, China's President Xi is now enshrined in their constitution, and will be a steady hand on the tiller

EQUITIES:

- The wide universe of choices on Tokyo's Second Section (small & mid-caps) provides the means for the best local managers to generate good and consistent risk-adjusted returns; investors may want to hedge the currency exposure
- If a true 'melt-up' in US equities cannot be avoided, this will have consequences for investment tactics
- …with the observation that typically the last 25% of equity bull market gains are made in the final period
- The S&P500 is trading at 17.6x 2018 earnings, with 10.6% forecast earnings growth - but estimate revisions for this year and next have just broken to the upside
- In Emerging Markets, India remains a firm favourite, based on growth and valuations a year or so out, as well as Asia-Pacific (ex-Japan)

BONDS:

- Investment policy in this asset class remains unchanged: underweight Governments, and overweight High Yield
- The major developed market bond yields we follow are still locked in ranges

FOREIGN EXCHANGE:

- With each of the major FX pairs being such different animals we find the dollar index (DXY) less and less useful
- …although having said this, the DXY appears to have formed a reverse-head-and-shoulders (one of the more reliable chart patterns), suggesting a further 2-3% of dollar strength in the short-to-medium term; more is possible once the Trump Administration's policies are passed

COMMODITIES:

- Oil: We are not surprised to see Brent crude trade above $60/barrel, with $65 now in sight for Q1 2018, based on good demand, and supply interruptions
- Gold: at $1,273.35, has neither broken up, nor down; remaining geopolitical uncertainty dictates maintained hedge positions
- Base Metals: Corrected slightly last week, and it is likely any 'dip' should be used as a buying opportunity

LASTLY…

- The FAB Asset Allocation Committee meets later this week, and decisions and key points will be discussed in next week's report
- We remain bullish on global equities, neutral overall in bonds, and heavily underweight in alternative investments as a class

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