From West to East

Weekly Investment View

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Navigating the turbulence

The S&P 500 fell 0.61%, to 2,461.43, during a week in which investors had numerous factors to assess, starting with the latest North Korean missile launch, extremely adverse weather across the Caribbean (in the form of Hurricane Irma, destined for Florida, and coming hard on the heels of tropical storm Harvey), continued angst regarding the US debt ceiling, hoped-for clues from the ECB monetary policy meeting, and the continuing weakness in the dollar. In the event, Democrats in the US Congress put together a proposed short-term fix for the US debt ceiling (an increase and extension to the 15th December), including funding for Harvey's relief effort, which President Trump intends to sign. Hurricane Irma was strengthening as it approached Florida. Turning to the dollar, the remarks made by US Federal Reserve member, Lael Brainard, suggested a dovish outcome to current policy deliberations, causing market expectations about the likely path of the Fed funds rate to soften further, to a probability of 26.9% (down from 33.8% the previous week) based on the usual Bloomberg-based analysis. Accordingly the dollar weakened still further, to 91.325 on its index (down 1.58% over the week), and below the significant 92.60 closing level. Other things being equal, the dollar has now been sufficiently weak for this to be supportive for US equity estimate revisions, and hence for S&P500 and other index valuations, especially in the case of the large overseas earners, thinking particularly of the large technology (and tech-related) companies. In other equity markets, the European STOXX 600 came off only slightly (by 0.17%), despite continued firmness in the euro/dollar currency pair, helped by a good performance by banks, which stand to benefit from any further upwards revisions to Eurozone business confidence and GDP growth (even the Italian banks could be now about to enjoy a leveraged improvement in their outlook). Elsewhere, the Japanese TOPIX fell by 1.61%, adversely affected by local geopolitical concerns, as well as the further strengthening of the yen vs. the dollar. Lastly, our favoured MSCI Asia Pacific (ex-Japan) index out-performed nicely over the week, closing almost exactly unchanged; China is important in this index, and marginal local currency stock price falls on average were more than offset by continued firmness in the Chinese renminbi. **We continue to favour Chinese equities, within the broader investment FAB Asset Allocation Committee policy stance of being overweight in Asia Pacific (ex-Japan) equities. Most stale bears of Chinese stocks continue to recount how the country has some debt issues, but few will mention that China has a domestic savings rate of over 30%.**

"FAB Asset Allocation Policy has a neutral – and stabilizing – weighting in global bonds"

Driven by reduced market expectations for US rate increases, together with higher risk aversion at the margin, the yield on US 10-year Treasuries fell by 11 ½ basis points, to 2.0507%, a break below the 2.12-2.15% level that we have described as technically significant over recent months. At the same time, the yield on the more policy-sensitive US 2-year fell by eight basis points, to 1.2620%. The yield on the German 10-year Bund fell by almost seven basis points over the week, to 0.3120%, while that on the Japanese 10-year rose very slightly (to 0.0040%), essentially anchored at zero. The ECB had been careful to outline before its Thursday meeting last week that market participants should not expect any policy announcements, and that any comment regarding the winding-back of its QE could be expected after the October meeting. Market comment last Friday suggested encouragement from Mario Draghi's economic optimism, but some frustration with the understanding that the ECB's discussions regarding the ending of QE had only been "very preliminary". In the Q&A session, Draghi again made remarks seemingly designed to keep euro strength in check, rather than directly attempting to talk it down – so avoiding getting drawn into a game of 'cat-and-mouse' with FX traders. In other central banker speeches made last week, the New

York Fed's Bill Dudley came across as being less hawkish than recently. In her speech, Federal Reserve Governor, Lael Brainard, was particularly dovish in her comments, essentially acknowledging that it could be a while before the Federal Reserve hits its 2% inflation target. Significantly, she argued against the position that inflation was staying low due to 'transitory factors', an oft-quoted point during recent years. She now believes the Fed should move slower on rate increases, and even allow inflation to run above the 2% target for a while. Brainard is considered ideologically close to Fed Chair Janet Yellen. **She sounded troubled that there had been five straight years in which inflation had fallen short of the Fed's target, "…despite a sharp improvement in resource utilization".**

"The hurricanes will weaken the US economy slightly in the short-term, but the rebuilding effort will be stimulatory"

Continuing for a moment the discussion of dollar weakness, it is worth mentioning that some softness is now expected in the US economy after the hurricanes. Indeed the US Labor Department last week published data showing a sharp increase in first-time claims for unemployment benefits in the week ended 2nd September, with jobless claims jumping to 298,000, up 62,000 from the previous week, and primarily due to the effects of tropical storm Harvey. Coming back directly to the dollar, during the preceding week US Treasury Secretary Mnuchin had said he wasn't particularly worried about dollar weakness, as it helps US trade. **So there is a sense that FX traders and other participants are happy to take him at his word, and to take him on.**

"From a global, rather than US viewpoint, oil demand appears to be supportive of prices"

In commodities, bell-weather base metal copper fell 2.47% (to $3.02/lb), in what is thought to be profit-taking after a series of relatively strong weeks. In crude oil, the active Brent contract rose 1.95% over the week, to $53.78, with its premium over WTI widening to $6.30, mainly reflecting storm-affected capacity hit by storm Harvey coming back on. Data on Thursday showed US crude stockpiles had recorded their first weekly increase in just over two months. Reports from various refineries suggest little structural damage. The global picture has been one of strong refining margins in the industry, indicating good end-demand. **In precious metals, gold closed at $1,346.59, up $21.36 over the week (or 1.61%) as hedging and trend-following demand increased.**

"The Chinese 'Caixin' Composite PMI is quite highly regarded as a statistic – and is looking good"

In economic data, the US Commerce Department said factory orders fell 3.3% in July, following an upwardly-revised 3.2% in June, and vs. expectations for an increase of 3.2%. In better news, the US ISM services PMI for August rose 1.4 points, to 55.3, recovering from the previous month. Although market expectations had been in the region of 55.8, a reading of 55.3 is good, and especially as this broad sector accounts for about 75% of the US economy. **In China, the latest Caixin services sector PMI for August came in at 52.7, up from 51.5 in July, driven by increased activity at manufacturers and services providers.**

"FAB Asset Allocation Committee policy is unchanged"

INVESTMENT SUMMARY: The hurricanes are short-term events, but these will be hugely costly for the US – for the insurance industry and the government. It appears that Congress is pulling together in these difficult times, despite remaining party differences. Tax reform may well be pushed out into next year, although we believe it will still happen, or sufficiently for US business and investors to feel the benefits. Regarding geopolitics, at least Trump has said that military action was not his "first choice" in dealing with North Korea. The dollar, while not exactly having been considered a safe-haven of late, certainly does look extremely oversold, and would now benefit from the slightest bit of good news. The extension of US government funding until mid-December is admittedly a quick-fix, but it is a start, and we would expect a more concrete solution to follow – especially as members of Congress want to be able to report progress to their constituents before and during 2018's mid-term elections. What could go wrong in the short-term? A cynical view might be that North Korea intends to launch a further missile just as Hurricane Irma is devastating Florida. **Be that as it may, the FAB Asset Allocation Committee's policy is medium-term in nature, and remains unchanged.**

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