## From West to East

*Weekly Investment View*
*24th September, 2017*

# The Fed States its case in continuing geopolitics

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### *"Korean tensions & more hurricanes dominate''*

**Markets started in a very similar fashion to last week. The rhetoric and war of words continued between America and North Korea after the North Korean missile launch that took place on 15th September, when it fired its Hwasong-12 missile over Hokkaido, Japan, for the second time this summer.** UN approved sanctions were shortly implemented that were underpinned by the Trump administration announcing yesterday an embargo on anyone having ties or doing business with Kim Jong-Un's regime. There was also the unexpected simultaneous surprise of China announcing a ban on textile imports and limiting its oil exports to North Korea. China remains North Korea's main trading partner. If that was not enough, hurricane 'Maria' battered the Caribbean again following on from hurricane 'Irma' just before, that left more devastation in its wake. The US administered territory of Puerto Rico was the latest casualty. Markets had had a strong negative reaction to similar events the previous week, where safe haven flows such as Treasuries and gold were the main beneficiaries. Instead, markets were more focused with what Janet Yellen and the US Federal Reserve Bank had to say about the path for future interest rates in the world's largest economy as well as the eagerly anticipated Fed's balance sheet run off that has been accumulated since the financial crisis of 2008. The Dow Jones closed marginally up on the week with a gain of just +0.44% with the S&P gaining +0.28%. In Europe, markets will be awaiting the German elections later this week although not much opposition is expected to the ruling CDU party with its leader Angela Merkel at the helm. What might be more of a market-moving event could be Austria's legislative election that will take place on 15th October. Recent polls there suggest the conservative party has 33%, the social democrats on 24%, but the far right Freedom Party of Heinz-Christian Strache polling more votes again, standing at 25% of the voting electorate that could upset markets, should he win. **In the UK, last week we saw a nice rally in the currency, the British Pound on a 'relief Brexit rally' that appeared to suggest the road ahead maybe smoother. Prime Minister Theresa May's speech last week on the subject left some in doubt as to whether it would be.**

### *"UK Brexit – 'I Love it when a plan comes together?"*

**Hannibal Smith of the TV series 'The A team' always seemed to have a plan in place in difficult times. British Prime Minister, Theresa May, finds herself in a uniquely difficult position however – regarding a plan how she and her team will engineer the 'wishes of the UK people' to leave the European Union. One that will change little in the coming months. She appears to be between a rock and a hard place on the intended outcome.** During her 'EU vision' speech in Florence, Brussels will want to see the colour of the UK's financial divorce settlement offer before the EU will discuss a trade deal. Negotiations so far have got nowhere, six months into the two-year wind-down to Brexit in March, 2019. These will re-start this week. Those in favour of Brexit in the UK were principally concerned about the excessive bureaucracy of the EU, the cost of it, and a creeping loss of national sovereignty. The EU is expected by some to demand up to the equivalent of $120 billion (the highest amount we have seen quoted, and depending on the accounting) to reflect spending pledges that the UK agreed to, for the EU budget round to 2020 – including loans to Ukraine and quaint environmental projects, as well as other liabilities such as pension payments. The EU says that it would not be fair for the remaining 27 states to have to cover the resulting budgetary shortfall. There are hard-liners in Mrs May's party who are in favour of a 'no deal' Brexit, epitomized by Boris Johnson's (UK Foreign Secretary) attitude that the EU can "go whistle" if it seriously expects the UK to pay a huge settlement (including future commitments) to the EU. During the last week Mr Johnson (who many still think would love to be Prime Minster) indirectly threatened to resign if Mrs May did not take a hard line with the EU. After the mishap of the June UK general election this year (in which the Conservatives lost their parliamentary majority), many commentators believe the Prime minister has been terminally damaged, and that at some stage in the months to come she will inevitably face a leadership challenge.

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**Boris Johnson has made it no secret a 'hard Brexit' view should win out. This could then potentially leave the UK facing a potential economic 'vacuum' in the EU, rather than a sensibly negotiated transition period. Boris Johnson said that the amount saved by the UK not being in the EU could be spent on the National Health Service, which sounds distinctly like a 'warming-up' comment to the UK electorate.**

### *"BoE wades into the argument"*

**Mark Carney, Governor of the Bank of England (BoE) in a speech last week warned that Brexit is likely to be inflationary for the UK, by reference to trade ties having been damaged, and more restrictive immigration rules causing wage levels to be increased. Sterling jumped last week (to $1.3550), reflecting a more overall hawkish view on rates from the BoE Monetary Policy Committee (MPC).** The headline UK inflation rate has risen to 2.9%, largely the lagged result of sterling's post-Brexit vote downward adjustment, and the BoE expects the CPI to move above 3%. Wage growth is negative in real terms, and although unemployment is at a multi-decade low, consumers are suffering. The Centre for Economics and Business Research now expects UK GDP growth to be 1.6% in the current year, and 1.4% in 2018, up from 1.3% and 1.2% previously. This is consistent with the BoE commenting that UK growth is slightly stronger than anticipated, and linked to the increasing tilt towards hawkishness on the part of the MPC. Many analysts now expect the BoE to raise rates in November, for the first time in over a decade. In reality, growth in the UK since the Brexit vote in June last year has exceeded expectations, helped by the beneficial effect of sterling weakness on exports, and (at least until recent months) the sense on the part of business that a satisfactory Brexit transition deal would be reached. In reality, the BoE finds itself in an invidious position in that its mandate is to keep the economy on the straight and narrow and (as for other central banks) it has to 'normalize' rates from the ultra-low level of 0.25%. The latter is of course very prudent in isolation, although even one rate increase could hurt the economy disproportionately if there is increasing political risk (i.e. from Boris and his hard-liners). As we put the finishing touches on preparing last year's Outlook 2017, Sterling was trading at just below $1.25, and our conclusion was "Sterling is still fundamentally worth $1.35-1.40", and (maybe fortuitously) the quote is $1.3540 as we write – although that was on the basis that by now markets would have a clearer idea about the broad parameters of Brexit. As we have noted, Mrs May is under great pressure not to agree to pay much at all to the EU, while the latter will not easily be moved by fancy proposals – for them, it is a case of "Show us the money". Sterling has historically been a 'big tick' currency .i.e. it is capable of some quite large short-term moves. **Especially if the US dollar rallies from its medium-term oversold position, sterling could be capped at close to the S1.35-1.36 level, while any persistence in what we see as a classic stand-off between the UK and the EU could imply at least a fall towards $1.25, and probably below.**

### *"Yellen to 'stay the course' while running off Fed's balance sheet"*

**Last Wednesday the US Federal Reserve bank announced no change to US interest rates. The Fed Funds rate stayed at 1.0%-1.25% range. 10 years on following the greatest financial crisis the world has seen since the great depression of 1929, the Fed announced the widely anticipated decision to unwind one of its key policy tools.** From October this year, the central bank's USD $4.5 Trillion balance sheet will slowly be reduced. Some have been concerned that with so much going on in the world both politically and economically was this the right time to embark on what is inevitable in the end? The Fed was careful. 'Baby steps' to start consisting of a balance sheet run off initially set at $6 billion of US Treasury's per month along with $4 Billion in mortgage backed securities (MBS) every month. This would rise every quarter eventually reaching a ceiling of $30 Billion per month in Treasury run offs in tandem with $20 Billion per month in MBS. 'Gently does it' for certain when you consider the height of Quantitative easing saw purchases reach $85 Billion per month in the heady days of 'Operation Twist' when the Fed took action to bolster markets by selling short maturity treasuries and buying long dated ones to keep interest rates down. Fed Chair Yellen also went on to say that along with this US interest rates could be raised one more time in 2017, with three rate hikes expected in 2018. Something that we have echoed since the start of the year in our 'Investment Outlook 2017'. The dollar index (DXY) got a much needed lift after being in the doldrums for many weeks. Some market participants were a little surprised given current geopolitics around the world, the hurricane damage that may lower overall US Gross Domestic Product for the year as well as the most important point being the lack of inflation in the US economy. The Fed set an inflation target of 2% some time ago. It's now 5 years in a row that this target continues to undershoot. Fed minutes from the July meeting showed voting members worried about a prolonged period of below trend inflation. Originally the Fed had forecast that 2% inflation will be reached in the US economy by June 2018. This is now been put back to 2019. Outside of this anomaly much has gone right for the Fed. The US economy is moving ahead quite nicely with GDP reaching the 3% target in Q2 this year. Consumer spending and employment are all doing well and after a period of elevated dollar strength this has pulled back in the benign inflation environment that has all helped the positive sentiment. The Central bank also reiterated that US unemployment was projected to stay at 4.6% while lowering its projection for the jobless rate for this year and next to 4.1%. Economic growth in 2017 it said would rise to 2.4% from the current forecast of 2.2% while core inflation is forecast to fall to 1.5% from the current 1.7%.

**The Asset Allocation Committee of FAB will be debating these and other events at its next meeting. Currently there has been no change to the investment strategy that still remains overall in favour of risk, namely overweight equities and high yield bonds over less risky assets like investment grade bonds and gold.**

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