Reassessment after a quick 'FAANG' shake-out

Having started the week under pressure from US social networking stocks - with Facebook particularly in the frame after recent data security concerns and the announcement of a Federal Trade Commission investigation - the NASDAQ Composite steadied at the end of the week, resulting in a rise of just over 1% over the period and the index hanging onto a gain of 2.32% for the year-to-date. The 'NYSE FANG+' index (composed of Facebook, Amazon, Apple, Netflix & Alphabet, parent of Google) still closed 2.28% lower over the week, hit towards the end by a renewed Trump-led 'hit' on Amazon, on the face of it based upon his belief that the company takes advantage of the US postal service (their "Delivery Boy"), in addition to his criticism that it pays little or no tax to state or local governments. We'll overlook the fact that Amazon's Jeff Bezos owns the Washington Post, which like others has been detailing recent White House events. The FANG+ index nonetheless remains 9.74% ahead for the year-to-date, and after many portfolio managers will have trimmed positions in constituent stocks in a belated attempt to do some end-of-quarter window-dressing - i.e. not wanting to be seen to be too overweight in FAANGs for that first important snapshot of 2018. Certainly the short-sellers who have been (on average unsuccessfully) trying to 'top-spot' the FAANGs over many months finally smelled some blood. **It remains to be seen whether their timing (again, on average) will be any better this time; certainly some lasting rating/earnings damage has been done to selected stocks.**

"The efforts to avoid a trade war, after initial hard-talk, have grown"

We expect that from this point what has been a fairly broad correction across technology - and especially what also passes for technology (social networking and E-Commerce) - should give way to a more stock-selective assessment i.e. favouring what we have recently called the 'genuine' tech stocks, with the likes of Microsoft in the vanguard. In the meantime, stocks considered to be quasi-tech, like Tesla, have in recent weeks fallen off a cliff-edge (in that particular case after two of its autonomous vehicles were involved in fatal crashes, superimposed upon other concerns). So just as commentators bemoaned the absence of normal volatility, now it has finally returned (as an example the VIX closed at 19.97 last week) they are writing as though it is unusual. **We said last week that concerns voiced about an impending trade war were wide of the mark - for instance South Korea will have a quota imposed on their steel exports into the US, rather than tariffs, while negotiations on automobile trade continues - and the better trade-related news of recent days is so far supportive of such a view.**

"Stocks do not - and should not - rise every quarter"

In the wider world of equities, the MSCI All Country World closed the first quarter down 1.41%, after recording advances for seven subsequent quarters. Within MSCI 'All Countries', developed markets were 1.74% lower, with emerging market equities 1.07% higher. The S&P500 closed 1.22% lower, Japan's TOPIX was -5.57% (although the yen strengthened from 112.69 to 106.28 to the dollar), the STOXX Europe 600 index also underperformed (-4.70%), while our largest proportionate overweight, the MSCI Asia Pacific (ex-Japan) index fell slightly (by 0.99%). The Chinese CSI 300 index was 3.28% lower in renminbi terms, but after adjusting for appreciation in the Chinese currency the index closed 0.35% to the good for the quarter. Turning to global bonds as defined by the Bloomberg Barclays Global-Aggregate Total Return hedged USD index, this closed very marginally lower for the year-to-date (-0.12%), and currently with an adjusted annualized yield of 1.83%. Looking at a leading metric for our own region, the Brent crude price closed 5.08% ahead for the year-to-date, at $69.34, right at the top of our inferred range of $70-55/barrel, and as we suggested a few weeks ago we expect to be edging that expected trading range upwards in the immediate weeks or months to follow. Gold in US dollars is almost static, at +1.03% for the year-to-date, as investors simply haven't felt they needed increased net exposure to it. The dollar in terms of its index (DXY: 89.974) is -2.33% for the year-to-date, admittedly trading below the bottom of our suggested lower limit of 91, and requiring a two or three-day close above that level to begin to silence the bears. Lastly, looking at local equities, Abu Dhabi equities are 4.25% ahead for the year-to-date, featuring Banks, and despite large ex-dividend adjustments. Dubai equities closed the quarter 7.76% lower, impacted by the real estate sector. **The entry of Saudi Arabian equities into the FTSE Russell Emerging Market equities index (from March next year) was a significant and extremely encouraging event for local capital markets last week, and we comment separately on this in a later paragraph; plus: Kuwait's stock market will enter FTSE Russell's emerging market index in two equal stages in September and December this year, with the index provider's estimate that Kuwait could be 0.4% of the index.**

"FTSE Russell described KSA's inclusion in EM as historic"

Before we discuss Saudi Arabia winning coveted 'Emerging Market (EM)' status from index provider, FTSE Russell, we should note that the IMF's Christine Lagarde a week or so ago said KSA is making "good progress" in its economic reforms, referring to examples such as the recent introduction of VAT, the steps taken to increase women's participation in the economy, but also including the decision to slow the planned rate of fiscal adjustment. The IMF recently estimated KSA's real GDP growth to pick-up this year to 1.1%, from a small positive number in 2017. In operational equity terms, the authorities achieved sufficient milestones to prompt the upgrade, including the initiation of 'T+2' settlement, and work towards establishing a clearing house allowing the use of derivatives. For the year up until just before the announcement, the Tadawul All Share index was ahead by just under 10% in expectation of a good result; it has since given back 1.8% of this, although this 'sell the news' kind of reaction is a normal development as stocks become subject to profit-taking. Having said this, the MSCI decision for KSA regarding their own EM index is expected in June, and there is every chance they will reach a similar decision. Estimates of capital inflows have varied: the Saudi exchange authorities are quoted as saying the positive decision from FTSE could result in about $3 billion of inflows; EFG-Hermes said inflows of about $15 billion could result if the MSCI decision was also positive, while market discussion reflected by Reuters mentioned more than $30 billion being possible over the next few years. FTSE Russell said KSA would have a potential weight of 2.4% in its EM index, which will be applied in a phased manner from next March. This index weight could rise to about 4.6% after the proposed Saudi Aramco IPO, according to the provider. **A Reuters poll of Middle East portfolio managers published late last week suggested 46% expected to raise their Saudi equity allocations over the next three months, and 23% said they expected to reduce them; our own take is that many of the former would be for structural, long-term funds, while the majority of the latter could be purely tactical.**

"Foreign interest in KSA stocks would be off a very small base"

It must be said that foreign interest in Saudi stocks in recent years (from 'qualified' investors and through swaps) has been very limited, at perhaps only 1.5% of market capitalization to date. Current market capitalization is about $500 billion, by far the Arab world's largest equity market. The Tadawul is trading on a P/E of 12.8x for the current year, below estimated EPS growth of 13.16% (for an attractive PE-to-Growth ratio of below 1x). The Saudi Aramco IPO is probably best delayed until into next year, when oil prices should be higher, irrespective of any necessary preparation still underway. FTSE Russell said the country weighting in its index after the IPO could rise to about 4.6%. **Of late, investors look to have been selling other trade-able MENA equities to facilitate the 'inclusion' trade - and perhaps certain UAE stocks, for instance, have become very over-sold i.e. it's not just all about real estate prices.**

"We view the S&P being 8% down from its high as the correction we expected"

INVESTMENT SUMMARY:

(1) In geopolitics: China is doing a good geopolitical job with North Korea, in everyone's interests, especially its own; North Korea's Kim is due to have a summit with the South Koreans in April, Trump in May, and maybe then with Japan. In MENA, the period after the US withdraws from the nuclear deal to be reviewed in May has to be faced. Lastly, we would note that Egypt is looking more settled than for some years, underlined by President Abdel Fattah al Sisi's second term in office.

(2) In central banking: The ECB may need to keep some QE ammo dry for longer: difficult government formations (Germany and Italy), the opposition to reforms (France), and Brexit - hence the divergent views from ECB officials.

(3) In world trade: the US and China are attempting to resolve trade and other differences (e.g. IP), with a strong yuan; the US has asked China to cut a tariff on US autos.

(4) In US economic statistics: The PCE 'core' inflation index (ex-food and energy) rose 1.6% year-on-year, up from 1.5% (Jay Powell told us it would track upwards - and possibly overshoot 2% for periods; six-month core inflation is now at 2%, with three-month annualized at 2.8%, due to higher healthcare prices in February. The upwardly-revised Q4 GDP number (to 2.9%, from 2.5%) is history but underlines the recent importance of spending on services in the economy; recently weaker retail sales is hence less of a problem, especially in light of still-good Conference Board and University of Michigan consumer confidence data. Economists expect a slight easing of annualized GDP growth in the quarter just ended, maybe to 2.4%. The two-year inflation breakeven (inflation expectations in markets) has moderated to 1.97%, from 2.16% in early March, and if borne-out is good news.

(5) Although equity market volatility has increased, this is now only at normal levels (note the VIX), and our structural risk-on stance for the year as a whole remains in place. The FAB Asset Allocation Committee, whose job it is to also make tactical adjustments to the asset grid to side-step perceived risks, meets later this week. **Below these 'top-down' decisions, our investment professionals must, for instance, make the right decisions in sectors such as Technology in light of any threats from a changing regulatory background, while still maximizing the upside from exciting technological developments.**

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