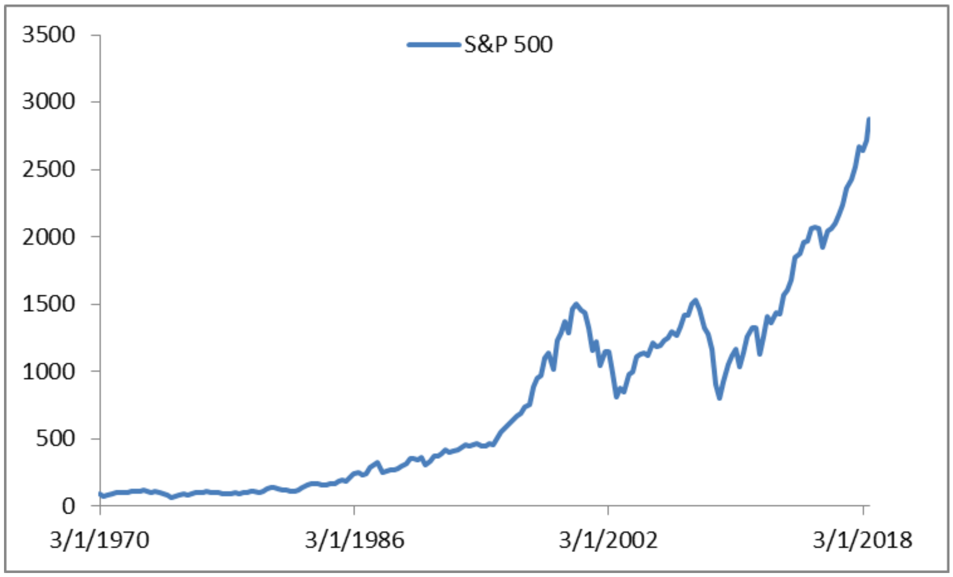
Investors should watch Washington as Wall Street hits highs



While Wall Street had an exciting ride last week the real action was happening in Washington DC. Two former aides and close associates of President Donald Trump's were found guilty of accusations including tax fraud and campaign-finance law breaches. Then, on Friday, the longtime Chief Financial Officer for the President's companies, Allen Weisselberg, was given immunity, a sign he is cooperating with authorities in the tax and bank fraud investigations that led to the conviction of Michael Cohen, who himself once acted as legal adviser to Mr. Trump.

The three events signal that the President is increasingly under siege from prosecutors in the US, including Special Counsel Robert Mueller, who is tasked with probing potential Russian meddling with the 2016 presidential election. This does not mean the President is under threat – yet. Since the 1960s, the Justice Department has followed guidelines that say it cannot indict a sitting president because that would interfere in his abilities to carry out his duties. In simple terms, the Justice Department excuses itself from engaging in politics, in line with the thinking of the nation's forefathers.

Mr. Trump, however, is not immune to all this. There is a significant chance that at least the House of Representatives will flip to the Democrats in the November elections, reducing the current control the Republicans have of Congress. There are 27 seats in that chamber for which the result is a coin-toss. Assuming the other 199 Democratic Party candidates seen as sure-shots win, and that half the unclear seats go to that group, the House would go into Democratic hands.

While that may be rather simplistic, the likelihood of such a chain of events is not small, particularly since the Democrats are reporting record numbers of small donations ahead of the midterm elections. Voting in the US is voluntary, so engagement is a key measure of who is more likely to win. If a lot of people are putting even a small amount of money into the campaign, they are more likely to show up at the polls and potentially swing the vote.

The very close election of Republican Troy Balderson to replace his fellow party mate Patrick Tiberi in a special election in Ohio concluded last week also indicated that the Democrats may be stronger than expected in November. Tiberi had held office since 2000 and won 67% of the votes for his district when he was reelected for the third time in 2016. The sudden narrowing of the winning margin for Balderson signaled a Democratic tilt in a traditionally Republican district, a sign that the November elections could be exciting.

If the outcome is a Democratic House, an investigation and potentially even impeachment procedures against President Trump may ensue. Whether they lead to the President's ouster is another matter – an American President has never been impeached and the latest one to face the procedure from the House, Bill Clinton, was acquitted by the Senate. In fact, as it stands, it is highly unlikely that an impeachment would end with Donald Trump out of office, given that two-thirds of the Senate would have to vote in favor of removing him.

If there are impeachment proceedings, they would not come without costs, including a likely spillover into financial markets. In fact, the investigations may already be taking their toll. Mr. Trump's trade war against China has stolen headlines and attention from news related to the convictions of his associates in a similar way that President Bill Clinton's bombing of Afghanistan and Sudan in 1998 redirected attention from news of his affair with intern Monica Lewinski.

When President Richard Nixon faced questions about his involvement in the Watergate scandal, he too used the war between Egypt, Syria and Israel as a means to divert attention.

"Donald Trump's trade and sanctions rhetoric could get more aggressive amid risks of a Democratic win in midterm elections and potentially more news of investigations related to his associates."

From West to East

Weekly Investment View
26th August, 2018

Away from Washington DC, investors were focused on what was happening in the balmy summer of the ski resort of Jackson Hole, where central bank officials gathered for an annual high-profile economic policy conference hosted by the Kansas City Fed. The key speech in the event was delivered on Friday by Federal Reserve Chairman Jerome Powell, and it helped spur the S&P 500 to an all-time closing high that day (see Bloomberg data chart above).

Investors focused on the Chairman's notes related to unemployment. In simple terms, Mr. Powell indicated that low unemployment no longer translates into inflation in the same way it used to. The comments were viewed as an indication that the lowest unemployment in almost half a century in the US will not necessarily spur the Fed to continue raising interest rates. Instead, the central bank will be watching inflation, which continues to hover around its 2% target.

Mr. Powell, however, also noted that in the past three decades "destabilizing excesses appeared mainly in financial markets rather than inflation." His remarks suggest he will be watching for trouble in the markets even though so far he has seemed almost immune to turmoil in global stocks and bonds. The key, here, however, is that the Chairman is focused mostly on the US, unlike his predecessors Janet Yellen and Ben Bernanke, who often appeared wary of any trouble in Europe or emerging markets. Still, if US markets start to suffer, Mr. Powell seems willing to act.

His words were still seen as an indication that the Federal Reserve could slow down its rate normalization path. The market continues to price in a rate hike in the next meeting, on 26th September. Implied rates also still indicate a 60% probability of another hike in December. That, however, is not in line with the thoughts of the FAB Asset Allocation Committee (AAC), which expects only one more rate hike this year in addition to the previous two the Fed made in March and June.

Further confirmation of any changes of expectations for the rate hike path will be given after the next meeting, when Fed voting members release their quarterly summary of economic projections, which includes the so-called dot-plot, a prediction of where benchmark rates are expected to be in the future.

The chances of a review to the current dot-plot in the near future are significant not only because the US economy is showing signs of flagging but also because three new permanent voting members of the Fed are due to take their seats as soon as they clear Senate confirmation hearings. At least one of these new reserve bank governors, Richard Clarida, who is set to take the Vice-Chairman seat, believes the so-called 'neutral' interest rate for the US economy is now closer to 2%, rather than the 4% the Fed used as a benchmark in the past.

Several leading indicators have shown signs of a slowing US economy too. The ISM Manufacturing PMI, a gauge of future production, declined to 58.1 in July from 60.2 in June, while the non-manufacturing index fell to 55.7 from 59.1.

"There is a significant chance of the Fed slowing down its rate hike path after September, which would favor risky assets."

What a dovish turn at the Fed could mean for global markets was on display on Friday. The S&P 500 closed at a record after rallying since February spurred by strong earnings growth driven by tax cuts and a healthy US economy. The dollar index dropped 0.54%, closing the week down almost 1%. That move, in its turn, translated into the best week for the MSCI Emerging Markets Index since February as it closed 2.7% higher for the week. The MSCI EM Currency Index, meanwhile, rose 0.34% over the period, its first weekly gain in a month. Among the components of the index, the Indian rupee rallied 0.36% to close Friday at 69.9088.

The list continues in fixed income, where the PIMCO Emerging Markets Advantage Local Currency Bond Index rallied 0.27% last week, while the Bloomberg Barclays Global Aggregate Index gained 0.55% and the ICE Bank of America Merrill Lynch US High-Yield Constrained Index rose 0.36%. Even gold, which had been beaten down recently by the strength of the US dollar, recorded a 1.78% weekly gain, its first larger than 1% since March.

The rally may have well run its course for the time being. There is still a lot of uncertainty in the world, starting with Turkey, which reopens its banks on Monday after a weeklong holiday that gave the country some respite from a currency crisis. Renewed pressure on the Turkish lira, which has already depreciated 37.8% this year to date, could prompt a new search for safety in dollars, Japanese yen and US Treasuries and away from EM.

That is consistent with the FAB AAC's recent decision to reduce exposure to EM assets. In that decision, however, the AAC noted that an entry point may soon present itself for the asset class, which is likely to benefit from the end of the Fed's rate hike cycle.

In the meantime, the Committee continues to prefer US stock markets, in particular sectors that focus on the domestic economy and are less likely to be impacted by trade wars.

"The outlook for EM remains uncertain for the time being and caution may continue to be the best policy."

INVESTMENT SUMMARY: Oil prices rose last week amid renewed supply concerns and a larger-than-expected drop in US crude inventories. The move confirmed the FAB AAC's expectations that Brent crude prices will remain between US$65/barrel and US$90/barrel towards the year-end.

Meanwhile, Saudi Arabia said it was postponing the IPO of Aramco to focus on the oil-company's acquisition of petrochemical company SABIC.

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