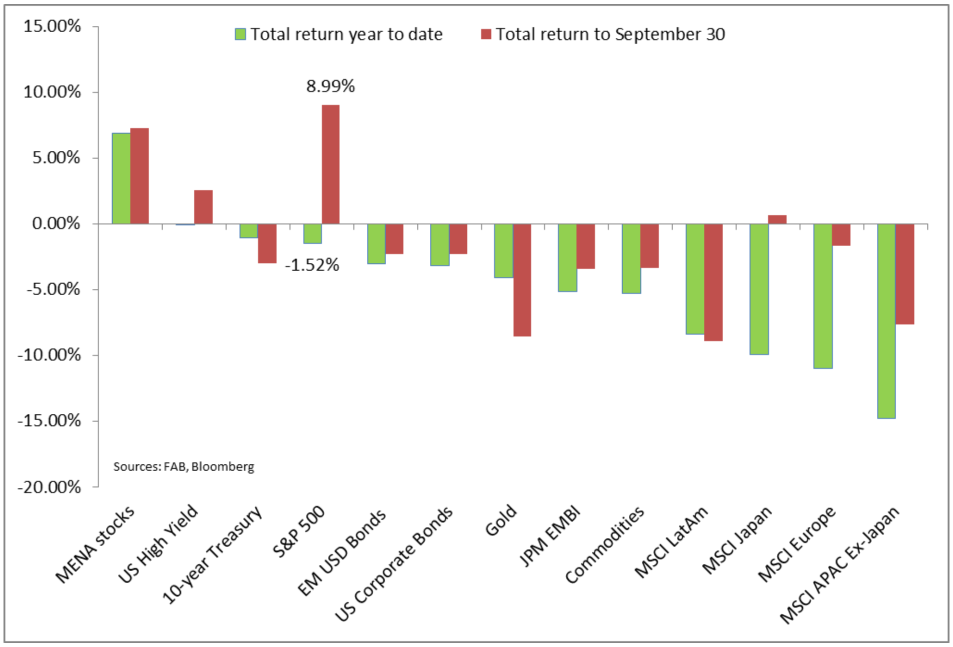
From West to East

Weekly Investment View

9th December, 2018

Investor sentiment is not reflecting a still sound US economy



The quarter to date has been difficult for almost every type of investor. But as the year-end nears, it is worth putting things in perspective. Despite some scary price action throughout the year, stocks in the Middle-East and North Africa (MENA) as well as in the US are still among the best performing investments so far in 2019, when almost every asset class generated negative returns. In fact, until the end of the third quarter, these two were the only key asset classes in the black. The fundamentals continue to be positive for both the US and the Middle East, but investors have become skittish amid rising trade war noises and fears that the Fed could overshoot in its monetary tightening efforts.

The US economy appears on track to end 2018 having grown about 3%, the fastest annual pace since 2005, when the real-estate bubble in the US was still inflating. The difference is that this time there is no 'irrational exuberance' in sight, and the strong economy is based on mostly real factors. Some could argue that the US is unlikely to keep growing at the pace it has this year, but it seems unrealistic to expect that next year will bring a recession in the world's largest economy. On the contrary, the median forecast among 77 economists Bloomberg surveyed indicates the US should grow 2.6% next year.

The Federal Reserve perhaps poses the biggest risk to that forecast. If the central bank tightens its monetary policy too much, it could topple the economy into recession, as it has done in the past. Its officials, however, seem aware of that and have started to sound more dovish. Chairman Jerome Powell, for one, two weeks ago said that benchmark rates may be close to neutral, which could imply that the Fed may pause after hiking rates in December. He did say last Thursday that the labor market remains strong, which was viewed as an indication that he does not plan to stop hiking rates so soon. That assessment, however, may have been called into question the next day as the Bureau of Labor Statistics revealed that the US created 155,000 jobs, 43,000 fewer than economists expected.

Unemployment still remains at a 49-year low of 3.7% and various other leading indicators last week suggested the US economy continues to do well. The ISM surveys of manufacturing and services managers, for instance, both positively surprised last week, a sign that growth is likely to remain strong. Meanwhile, 76.3% of the S&P 500 companies reported higher-than-expected earnings in the third quarter, with average earnings growth of 28% compared to a year earlier. Those numbers suggest there is no impending bear market.

"The US economy remains strong, consistent with higher US stock prices."

Investor psychology may be to blame, given the lack of fundamental reasons to explain the drop in stocks for the past two months. Indeed, the sell-off began in early October, shortly after Jerome Powell made a statement indicating benchmark rates still had to rise significantly to reach a neutral level. At that point, US stocks were the best-performing major asset class in the world, up almost 9% between 1st January and 30th September (see chart above). The sudden prospect of an over-hawkish Fed seems to have spooked investors who then sold US stocks in fear that higher interest rates would push the country into a recession. The moves since then have been so violent that Powell's rhetoric has changed, perhaps in response to them. Whether the expected path of interest rates has also shifted will become clear after the next Fed meeting on 19th December.

The fear of excessive tightening also hit the market at a time of lower liquidity in stocks and amid higher prevalence of automated trading strategies, which may have amplified the movement. Hedge funds that trade stocks based on algorithms tend to quickly sell or buy stocks depending on the direction of the market and based on key technical

levels. These investors add bearish bets to profit from negative momentum when the market moves down, and vice-versa.
On the flip-side, traditional value and contrarian investors have had a tough year, and may have lacked the financial or mental fortitude to buy stocks as they become cheaper. With fewer buyers and more sellers, the S&P 500 corrected. The index has lost 10% of its value since its recent peak on 3rd October. However, bull markets tend to have occasional 5%-10% corrections on their way up, usually when some investors lock in profits.
It seems like this may have been just what happened. Investors who made money through the end of September perhaps felt that there was too much uncertainty in the next three months and decided to lock in profits by selling or hedging their positions. Those who reached the fourth quarter in the red probably had to start liquidating positions as well to prepare for redemptions at the end of the year. Now, what could happen is that, as 2018 comes to an end, the successful investors will be tempted to go back into the market, while those who survived may renew their bets. This could stop the negative momentum.

"The recent rout in US stocks could be nearing its end."

As for some key uncertainties rattling investors, they remain in place. The trade war with China, for one, took a more serious tone last week after Canadian authorities revealed they had arrested Meng Wanzhou, the Chief Financial Officer and daughter of the Chairman of China's Huawei, the world's second largest smartphone maker. No official reason was given but media speculated that she was held because of alleged breaches of US sanctions against Iran.
Huawei is a key telecommunications technology player and is at the forefront of a debate over intellectual property theft, a key issue in the trade dispute between the US and China. That led investors to bet this was Washington's way of showing Beijing that the US could undermine the country beyond tariffs. Fears of Chinese retaliation helped swing the S&P 500 wildly last week. Those moves may have been exaggerated, though.
Privately-held Huawei has been accused of ties to the People's Liberation Army and the Chinese government, an allegation the company has been at pains to deny. The company is the biggest seller of 4G network equipment in the world, with more than a quarter of the market, and is expected to take an even bigger chunk of 5G, the next telecommunications standard. National governments could feel uneasy about allowing the company to pepper their countries with its antennas if it becomes clear that it has government backing. If China were to forcefully react to Meng's arrest, it would strengthen these rumors, something Beijing would rather avoid.
This means that China is likely to continue trade negotiations with the US, which were restarted in a meeting between President Donald Trump and Chinese Premier Xi Jinping during the G-20 meeting in Buenos Aires last week. That encounter was held one day after Meng had been arrested – although the fact was not yet public – and has already yielded some results. Last Tuesday, Beijing announced rules to step up punishment of intellectual property violations and later the country indicated it plans to buy more agricultural products from the US. While the arrest has added a dark cloud to the issue, it probably has not deeply changed the course of negotiations.

"China is unlikely to react too aggressively against the arrest of a Huawei executive."

The outcome of Brexit, another source of uncertainty, however, has become ever more unclear. On Sunday British newspapers carried stories suggesting Prime Minister Theresa May could request a Parliament vote on her EU departure deal be delayed amid concerns it would be voted down. Her government denied the rumors, but the fact remains that she has little support to pass the deal. If she loses, there is the possibility of a new referendum being called, which could only add to the uncertainty about how, when, and even whether the UK will leave the EU. As of now, the country is due to leave the Union on 27th March. That uncertainty has weighed on both the British pound and the euro, pushing the dollar higher and helping explain the underperformance of emerging markets, commodities and European stocks. Once that is resolved, there is room for these asset classes to gain.
All of the above was discussed in the latest FAB Asset Allocation Committee (AAC) meeting on Thursday. Members even considered removing the underweight position in emerging markets given how much the asset class has lost this year. However, they decided it may be premature to make the move, and noted that continuing to be selective would be key. The members were happy to remain overweight in US equities, particularly given the now even more compelling valuation for the asset class.

"OPEC coordination and peaking US supply could help oil prices recover."

Similarly, the AAC remains bullish on MENA markets, which have already performed well this year, boosted in part by higher energy prices. While crude oil has not been spared from the fourth quarter sell-off – the cost of a barrel of Brent crude has dropped 28.5% since 3rd October – the medium-term outlook for the commodity remains positive. The supply overhang is likely to be reduced after 'OPEC+' agreed to cut production by 1.2 million barrels a day in the first quarter of 2019. That is likely to happen just as production in the US is likely to begin tapering off as well. The OPEC news boosted oil prices on Friday and is likely to continue to support the commodity, perhaps bringing it back into the AAC's expected range for 2019 of US$65-US$90 for Brent crude.

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