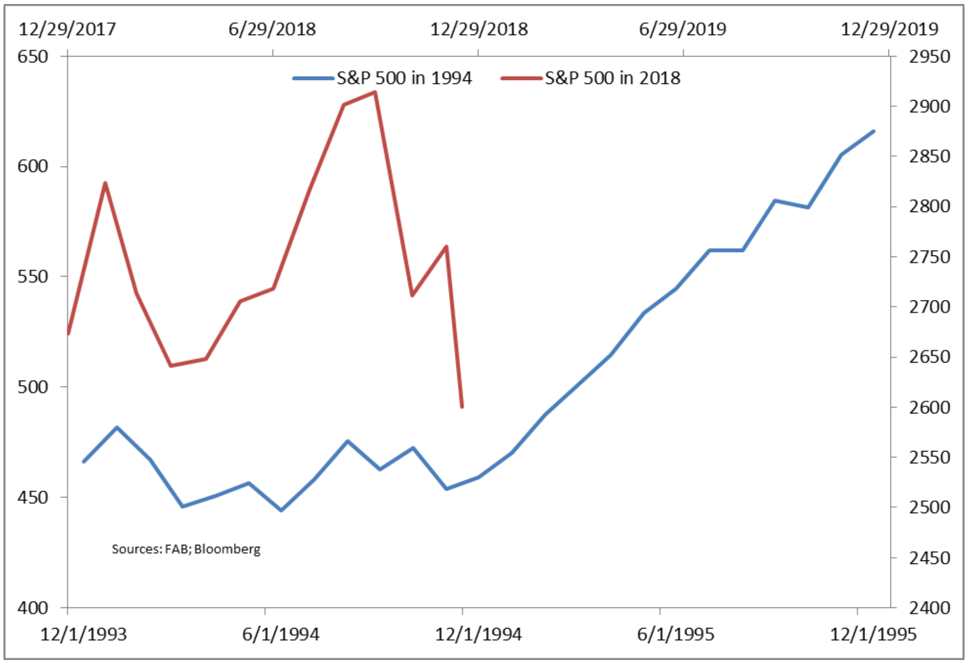
Some good assets are cheap, even if it may be hard to believe



Every December, asset managers across the globe engage in a tiring and, in years like this one, painful exercise. They have to report to their investors what they had in their books and how much money they made or lost. In some corners, this is a time to square some positions, perhaps add some stocks and bonds that performed well, and avoid the impression that fund managers may have missed a rally. Many losing positions get sold too, so they do not feature in the list of holdings that make it to clients' desks in the first weeks of January. This exercise, called 'window-dressing', has a way of extending some of the year's trends into a last leg before December closes.

'Window-dressing' can mean that even if some assets are now cheap, they are unlikely to rally strongly before New Year's Eve. It also has been a bad year for many assets, and the negative momentum can be such that depressed assets may not rally in the first weeks of the new year either — it is hard to stop a moving train.

For those investors not constrained by calendar-determined factors, however, times like these are a boon — they can pick up cheap assets that may well generate outsized returns over the long-term.

Take US stocks, for instance. After a rollercoaster ride, the S&P 500 is down some 2.8% for the year-to-date. Yet, US equities have still been one of the best-performing asset classes. The main winner across all asset classes was cash, which beat most others as rising rates allowed better returns on US Treasuries and on bank deposits.

The last time this has happened was in 1994, when the Federal Reserve was raising rates from what seemed, at the time, ultra-low levels in a series of back-to-back hikes, very similar to what happened this year. The S&P 500 ended that year 2% down after a volatile ride. The following year, however, the index rose 33.6%.

"The last time cash beat US stocks, in 1994, the S&P 500 went on to gain 33.6% the year after."

It may not be any coincidence, either, that the S&P 500's stellar performance in 1995 coincided with a reversal of the Fed's stance. After increasing the Fed funds rate from 3% to 6% during 1994, Alan Greenspan led the FOMC to stabilize and then cut rates back to 5.5% in 1995. As the Fed's rate-setting committee meets for the last time this year, this Tuesday and Wednesday, it is almost certain that they will raise the benchmark rate to 2.5%. However, whether they will repeat this another three or so times next year is now much less certain.

The Fed still has plenty of reason to keep raising interest rates, at least from the perspective of the US economy – which is the one that matters to the Fed. Consumer spending data revealed last week saw higher growth than expected, and 'core' inflation (excluding energy and food) came in at 2.2% year-on-year, above the Fed's 2% target. Average hourly earnings grew at the fastest pace in 18 months, a sign that more inflation may be looming too, particularly considering how tight the labor market has become in the US, where unemployment remains at the lowest in 49 years. Industrial production also surprised on the upside.

Those numbers, however, are in the rearview mirror. Going forward, the US economy still looks strong, but not as much as it was earlier this year. Leading indicators such as purchasing manager surveys last week were not as bullish as economists had expected. Indeed, as the Fed's four rate hikes so far feed into the economy, US growth is expected to slow down to about 2.6% next year, from the expected 2.9% for 2018. This is still fast enough to warrant the Fed increasing rates a couple more times. The central bank may, however, pause in order to be sure that it is not overdoing it.

If the US economy is still doing fine, this cannot necessarily be said about the rest of the world. Again, that does not directly affect the Fed's decision, which has a mandate to look after the US only. Still, in indirect ways, of course what is happening economically elsewhere does matter.

The speed at which the Fed has increased interest rates has helped to strengthen the dollar. That is a drag on US exports, which in their turn reduces US economic growth. That is part of the reason why inflation has still been tame in the US (it remains relatively cheap to buy foreign products, even including tariffs), and why the US trade deficit was the highest in a decade in October. It is a fairly simple equation: short-term rates in the US have gone from 0.5% to 2.5% in two years. Meanwhile, rates have remained negative or close to zero in Europe and Japan. In such an environment, dollar investments become relatively more attractive and the currency strengthens.

That will only reverse when the Bank of Japan or the European Central Bank start to increase their own rates, even if they do it at a much slower pace than the Fed. While that may still be far in the future, the first steps in that direction were taken last week. The BoJ, for one, bought fewer than expected bonds in the market. The ECB, in its turn, announced that it stopped growing its balance sheet after it increased it by EUR 2.5 trillion in only three years. This does not mean the end of quantitative easing. The Central Bank will continue to reinvest the money from bonds that mature, it is just not buying more.

This, however, has already been sufficient to worry investors about the future of the European economy, especially after it gave signs of slowing down. Purchasing manager surveys for both Germany and France last week suggested an economic contraction ahead. In France, the situation is made more complicated by the lingering 'yellow vests' protests, which are continuing and dampening activity.

Meanwhile, the other large economy in the bloc, the UK, is dogged by its own political issues. Prime Minister Theresa May survived a vote of no-confidence from her own party, on Wednesday. The move means that Tories cannot challenge her leadership for another year. Her victory, however, may have been more of a defeat, as 117 MPs voted against her. The number came short of the 158 that would have removed her, but was proof that she does not enjoy widespread support across her own Conservative party, and, therefore, has no hope of getting her Brexit deal approved in Parliament. Furthermore, to win the 200 votes in her favour Mrs. May had to commit she would not lead the party into the next election.

This opens the door for an earlier challenge to the minority government. It is unlikely that the Labour Party will challenge the Tory-led coalition ahead of the Brexit deadline, on 29th March. Jeremy Corbyn, the Labour Party leader, is probably heeding Napoleon's famous words: "Never interfere with the enemy when he is in the process of destroying himself." Once Brexit is done and dusted, however, it is possible that Labour could challenge the minority government and win. That outcome could lead to a new government under the left-leaning party and Mr. Corbyn himself. Such an outcome would add another layer of UK-aversion to the cloud of uncertainty in which British assets are currently shrouded. The price action in the British pound as Theresa May was challenged this week offers a glimpse of what to expect. When she delayed the vote on her deal on Monday, the currency dropped 1.3%, and continued to fall on Tuesday, though it recovered more than 1% on Wednesday as traders bet she would win the confidence vote. A Labour government would continue to weigh on the pound, particularly if it comes after a messy Brexit.

As for the divorce from the EU, that has become increasingly binary. Given the lack of support for the deal Mrs. May agreed with Brussels, that deal is as good as dead. Her lack of support within her own party suggests she has little power to negotiate a better deal as well. Indeed, the discussion has become so divisive in the UK that any deal Mrs. May presents is likely to be shot down in Parliament. This suggests a 'Hard' Brexit should now be the base case scenario. The potential alternative to that could well be another referendum. However that might see Brexiteers even more empowered and could lead to a similar outcome to the June 2016 vote, causing even more disarray. This all suggests the outlook is bleak for the British Pound. That, together with the upheaval in Europe further supports the rise of the dollar.

"Political uncertainty in the UK and Europe is likely to continue to support dollar strength."

If market observers thought they saw drama in the UK, it could be because they were not paying attention to India. On Monday, while Theresa May was delaying the Brexit deal vote and triggering the no-confidence vote against her, Urjit Patel, the Governor of the Reserve Bank of India, resigned in a surprise move. The announcement came out after the spot rupee market had closed, but non-deliverable forwards – traded offshore around the clock – quickly rose 1.3% on the news. The move was subsequently mostly reflected in spot prices, though local banks tried to staunch the rout by selling dollars on Tuesday. That helped the rupee recover a bit, but news of the unexpected strength of the opposition in three state elections continued to weigh on the currency, and the rupee ended the week down 1.5%.

"Markets probably have not discounted the probability Modi does not remain Prime Minister."

The Indian National Congress Party, led By Rahul Gandhi, got the majority in Chhattisgarh, Madhya Pradesh and Rajasthan, three states where Narendra Modi's ruling BJP had taken 70% of the 519 seats in the previous elections. The outcome signaled that Modi's hold on the position of prime-minister may be more tenuous than markets expect. Even considering the fact that his BJP retains a lead in the polls, and probably will continue to hold the majority of Parliament, Modi may have to make way for another leader if the party's representation drops too much. Markets do not like change, and that would, so far, be an unforeseen one. As Urjit Patel showed, surprises should be expected in India, hence, until the elections (expected in May), investors may want to approach the country's assets with care.

For inquiries related to this article, please contact:

Alain.Marckus@bankfab.com or Christofer.Langner@bankfab.com

From West to East

Weekly Investment View
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