From West to East

Weekly Investment View
4th February, 2018

The correction we were looking for – wait to buy; don't sell

The S&P 500 index closed 3.85% lower over the week and the same amount below its all-time high (at 2,762.13). We had been saying a correction was due – no bull market can (or should) continue in such a manner without a pause. In summary, last week's equity correction looks like a healthy development to us. The US non-farm payrolls report contained data showing year-on-year wage growth rose to 2.9% in January (a nine-year high), leading some market participants to worry that the Fed may hike four times in the current year, rather than the three that many expect. The stronger wage growth - something that the Yellen-led Fed had been looking for in recent years as a further prerequisite for raising rates - was instrumental in the run -up in US bond yields (to 2.84% on the 10-year), together with some likely over-interpretation of a small change in statement wording vs. previously after the Federal Reserve's policy meeting earlier in the week. Also, there remains the strong chance of a further US government shutdown after the 8th Feb if Republicans and Democrats are unable to resolve their budget (and immigration) policy differences. January's US non-farm payrolls increased by 200,000, about 20,000 higher than expectations, as foreshadowed effectively this time by the private ADP data published a few days earlier. The unemployment rate remained unchanged at 4.1% as new entrants joined the labour force. The Federal Reserve (as widely expected) left the Fed funds rate unchanged, within a reference band of 1.25-1.50%. The usual Bloomberg model suggests just above a 92% probability of a rate hike in March, hence the markets have effectively fully discounted this. **The swaps market now indicates 4-5 hikes by early 2020 (to 2.50%) with this being close to what we expect, and as long as the rate in reality does not exceed about 3.50% equities should not be impacted provided consensus earnings growth assumptions continue to improve - as we expect.**

"A few negative surprises in tech stocks will produce buying opportunities in the sector"

The weakness in US equities was marked last Friday, with the S&P falling by 2.1% following the spike in bond yields after the wage data. The market adjustment was reflected by the VIX (volatility) index rising sharply during the week, to 17.31 (from 11.08), so it has returned quite rapidly to the mid-point of its historic 15-20 trading range. While it was a large move, this signifies more reality and normality than for almost 18 months. The NASDAQ Composite index fell by (only!) 3.53% over the week, despite Apple and Alphabet (Google) results disappointing; the markets had already begun to take note of signs of a slowdown in iPhone sales via pipeline checks at its component suppliers. In other markets, the STOXX Europe 600 index closed 3.12% lower. **The MSCI Asia-Pacific (ex-Japan) index closed 2.52% lower over the week; the latter markets remain our most enthusiastic overweight position.**

"The US 10-year yield has run-up too fast – although we have highlighted a 3% upper limit for 2018"

The 10-year Treasury yield closed at just above 2.84%, up a large 18 basis points over the week, and provoked equity downside - although as a result US equities are almost at a stroke more reasonably valued vs. the 10-year bond, helped by earnings estimates rising further. In other words the 'equity risk premium' (the extent to which the forecast earnings yield on stocks exceeds the yield on the US 10-year) increased. Hawkish statements from ECB officials regarding the possibility of reversing its QE, with confirmation of improved Eurozone growth helped boost the yield on the 10-year German Bund yield by just under 14 basis points (to 0.767%), further extending the breakout above the previously technically significant level of 0.50%. We wrote only a few weeks ago in our Outlook that we wouldn't be surprised to see the US 10-year yield trade up to 3.00%. While momentum can be a powerful thing, the move to 2.84% looks to have occurred too quickly. The Fed last week noted they expected (in light of good gains in employment, household spending and capital investment) the economy to expand at a moderate rate and for the labour market to remain strong in 2018, adding that inflation on a 12-month basis was expected to move up this year, to stabilize "around the Fed's 2% target over the medium-term". Accordingly, the FOMC expected economic conditions to evolve in a manner warranting further gradual increases in the federal funds rate, said the statement, adding the word 'further' twice. Commentators have alighted on 'further', which to us simply refers to the fact there have been some rate hikes but that more are expected (which we know – even if we can't predict exactly how many). With the sense that yield support was now arriving for the dollar - and with the markets more willing to overlook Trump-related political considerations (e.g. the ongoing spat with the FBI), the US dollar closed slightly higher on its index over the week (at 89.195, vs. 89.195 at the end of the previous week). **The sharp run-up in the euro ran out of stream (at $1.2463), the dollar rose by 1.46% vs. the yen (to ¥110.17), and cable closed at $1.4118 (vs. $1.4160 the previous week) as it became clear the background to Brexit negotiations isn't as good as recently thought (as we said last week – in addition to noting that Mrs May remains under immense pressure).**

"Strength in the Chinese renminbi should be welcomed by investors"

Also in FX markets, it is worth mentioning that the Chinese renminbi has been very strong recently, having seen the strongest month in January for a number of years. The dollar is 3.17% lower vs. the onshore (official) rate since the year-end. While the daily rate is set officially, the Chinese central bank has almost certainly become more market-responsive over time. Many FX analysts look to be simply extrapolating dollar weakness/renminbi strength. The official rate closed at $ = 6.3008 on Friday. While such a rate may ultimately hurt export earnings, one must consider the benefits from the effective moderation in local commodity prices from on large imports of raw materials priced in dollars. From a policy perspective we last week likened the currency move to the Chinese almost saying, "Well Mr Trump, you have been unhappy about the trade deficit the US has with China, so let's see what you can do with this stronger renminbi". **In addition, while the Chinese central bank doesn't want large flows of hot money into its currency, it does send a clear message regarding the future avoidance of currency outflows (which had in any case already stabilized).**

"The outlook for oil prices still looks positive, although not yet exciting"

In commodities, Brent oil settled at $68.58/barrel, 2.75% lower over the week. The International Energy Agency said the US is poised for strong growth in oil output, resulting in it exceeding the production of both Saudi Arabia and Russia. Otherwise, also capping prices in the short-term was the fact that US Energy Information Administration data showed a surprise increase in US crude inventories of 6.8 million barrels in the most recent week, after 10 weeks of declines. In overall sentiment terms this was partially offset by a surprise 2 million-barrel drawdown in US gasoline stocks. **Gold was 1.16% lower over the week, at $1,333.39/oz, if anything registering the fact that the yellow metal does not earn interest in the conventional sense, and that the opportunity cost of holding it is therefore rising.**

"The investment outlook is positive for risk assets this year"

INVESTMENT SUMMARY: It looks increasingly as though the long-awaited correction is here, and we have quite rapidly already seen 4% of it if one considers the S&P as the guide. Trump's State of the Union speech contained few surprises, and was well delivered. In our opinion, if the Republicans can just squeeze an infrastructure bill through Congress – even if it's not the full $1.5 trillion-worth of new spending they would like – that would be the second most important brick in the wall of what would be then be a very large agenda.

Infrastructure spending typically delivers good multiplier effects. We believe the current negatives (with the slim Republican majority in the Senate, and the machinations of the ongoing Russia investigation being at the forefront) are likely to once again be overwhelmed by market attention to earnings growth, which was already looking good. If anything untoward happens to Trump, the US has checks and balances – and many investors might even breathe a sigh of relief. Yes, interest rates are going to rise, but as we recently wrote in our Outlook, the expected extent of these should not damage equities. Meanwhile, globally, growth is gradually gathering momentum, in line with our expectations, and although US and global inflation are picking up, these factors should remain under control. US core inflation on the Fed's preferred PCE basis was 1.52% year-on-year, up from 1.46% the previous month. We still believe in - despite the sources of short-term volatility we have identified – a positive outlook for risk assets for the current year. Our favourite region and broad asset class is Asia-Pacific (ex-Japan) equities. A note of overall caution would be that from this point investors should pay close attention to quality, avoiding poor balance sheets and questionable business plans, as although the level of absolute interest rates vs. history should remain low, those companies (and governments) which built debt when it was abnormally-cheaply priced will be bound to suffer. **The Asset Allocation Committee meets later this week, and we will advise you of any outcomes to those discussions. As you would expect, the outlook for the US dollar will very much feature. Lastly, the Indian budget and the implications for those assets will be covered in a separate article.**

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