From West to East

Weekly Investment View
11th February, 2018

FAB Asset Allocation Committee adds to global equity overweight into weakness

The S&P500 closed 5.16% lower over the week (at 2,619.55), 8.82% below the all-time closing high of 2,872.87 posted late last month - so off Thursday's lows of greater than 10% below the closing high, and after some very wild swings as weaker holders liquidated. In last week's report we suggested "Wait to buy/don't sell" equities. This week we are saying "Buy/ add to global equity positions". Last Monday was the worst day for the S&P and the Dow since August, 2011, with structural bulls (like ourselves) beginning to sense an opportunity to add to long positions, despite the chance of a further US government shutdown later in the week (there was one, but it only lasted a few hours before the all-important US budget deal was agreed, and signed by President Trump). One of the key points (alongside the bullish view on global equities) in the 'FAB Global Investment Outlook 2018' was that we expected volatility to return. The closing VIX (volatility) reading last week was 29.06, (vs. a range of about 15-20 in times of more normal volatility), up from the close of 17.31 the previous week, although thankfully below the 50+ level reached momentarily intra-day early last week. Admittedly we didn't have readings in the 50 region in mind! **Markets these days have become even more 'instant' (in terms of the way they discount new news or views), so provided investors and their advisors have clear market views it can pay off to operate opportunistically/tactically if a short-term countertrend looks to have gone too far.**

"The US budget deal, together with tax reform, will stimulate the US – and other – economies"

With the market already braced for the possibility of bad news (i.e. a further US government shutdown), US equity (and other) markets saw renewed downside on Thursday, which carried over into Asia and the Far East early on Friday. However**,** a bipartisan agreement was reached in Congress after which President Trump signed a large spending deal into law after both chambers of Congress approved the bill early on Friday morning (EST). The bill will result in a two-year, $300 billion boost to spending on military and domestic programs. It also extends the debt ceiling, and authorizes almost $90 billion more in aid for 2017's various natural disasters, helps fund the response to the opioid crisis, and also extends the Children's Health Insurance Program for an additional four years (important to Democrats). There had of course been a measure of opposition from conservative GOP and other lawmakers to the plan in its totality, based on its likely effect on the US budget deficit. Meanwhile, the Democrats still want to see adequate provisions made for the 'Dreamers', hundreds of thousands of young immigrants in danger of deportation. Treasury Secretary Steven Mnuchin applauded the bill's passage (and we note for our readers his message and analysis of months past that the combined effect of the Trump Administration's economic initiatives should lead to higher economic growth – which in turn should offset the initial increase in government debt). As in the nature of such compromises, neither side got everything they wanted, but we were slightly surprised by the rapidity with which the latest agreement was reached – we thought it would take longer. The legislation funds the government through to the 23rd March while lawmakers finalize an appropriations bill with the levels dictated by Congress (followed by appropriations legislation for the current fiscal year ending 30th September, and the following year). **We believe there will be less purely political pressure on the dollar as a result of the passing of this budget.**

"Our favourite equity overweight remains Asia-Pacific (ex-Japan)"

Unsurprisingly the US equity correction dragged other global equities down with it. European stocks were 5.01% lower over the week in terms of the STOXX Europe 600 index, Japan's TOPIX closed 7.09% lower, and Chinese stocks corrected by 10.08% on the CSI 300 index (having been amongst the recent winners). **Our favoured broader MSCI Asia-Pacific (ex-Japan) index (a quarter of which is China) closed 7.31% lower, slightly worse than the MSCI EM average (7.15% lower over the week), and which remains our largest overweight equity position.**

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"The outlook for the Indian rupee appears very stable"

In fixed income, US Treasuries closed slightly lower over the week (with the yield on the 10-year bond up one basis point, to 2.8512%). The equity sell-off in the US had encouraged a move back into Treasuries. Meanwhile, the yield curve between US 2- and 10-year bonds steepened as the 2-year yield corrected by just under seven basis points (down to 2.0732%); with the benefit of hindsight it is easy to say this policy-sensitive rate had risen too far, too fast. A further downward correction in this now looks likely, and would be generally helpful to markets. In FX markets, the dollar rallied by 1.40% on its index over the week (to 90.442) as the bears came up against the bipartisan US budget deal. The euro/dollar pair was 1.69% lower over the week, with the yen 1.24% stronger vs. the dollar, at ¥108.80. Elsewhere, in the major currencies, cable traded 2.06% lower (to $1.3827), as Brexit worries resurfaced mainly in the form of EU negotiator Barnier's latest aggressive stance, to the effect that a transition deal for the UK was not 'a given'. Relative sterling strength earlier in the week resulting from a more hawkish stance on rate policy from the Bank of England gave way to more practical considerations: the EU cannot make Brexit appear easy. Elsewhere in foreign exchange markets we will lastly mention the USD/INR pair, in the light of Reserve Bank of India policy, and borrowing heavily from the latest view from our FAB Global Markets colleagues. Their short, intermediate and long-term expectations centre around 64.00, vs. Friday's close of 64.3975. In its monetary policy meeting last week the RBI kept its policy rate on hold, and maintained its neutral stance, despite indicating that inflation risk was skewed to the upside (i.e. expecting a 5.1% annualized rate in the first quarter of fiscal 2018 (up from 4.7%). **The yield on India government 10-year bonds closed at 7.490% last week, down from a recent high of 7.60%, and we remain firm holders.**

"It's good to have fewer speculative positions in oil – which continues to rebalance fundamentally"

In commodities, oil prices fell more than 3% on Friday, contributing to a fall of 8.44% for Brent over the week (to $62.79/barrel). Although a fair bit of downside over the week, we regard this as a correction within what remains a fundamentally improving situation. Oil could be just a few dollars away from a reasonable accumulation point, provided hedge fund liquidation is thought to have run its course. WTI fell by 9.55%, as trading longs were liquidated and influenced by falls in other risk asset prices. **Gold fell by 1.25% over the week, to $1,316.65/oz – which is deemed to be a very positive result for the underlying health of risk assets, particularly equities.**

"US corporates may not yet have pricing power – but they will pay less tax, offsetting this"

INVESTMENT SUMMARY: The Asset Allocation Committee met twice last week and made the following changes to the model portfolios:
(1) The overweight in High Yield bonds was reduced to neutral, and the proceeds were exactly sufficient to:

(2) Increase the previously underweight position in Developed Market Government bonds back to neutral – hence a de-risking exercise in the event that default rates on higher-risk corporates increase.

(3) The overweight position in North American Equities is to be increased into current weakness.

(4) Moving to overweight (from neutral) in Emerging Market Equities as a group, thereby diversifying the global overweight in equities, and using the superior growth expected in EM vs. Developed. Only MENA Equities remains neutral, the rest now being overweight.

(5) Changes (3) and (4) above to be paid for by further reducing the already underweight position in Alternative Investments – Hedge Funds, and also out of Cash/Money Markets (the latter being already underweight).

For any inquiries related to this article, please contact Clint.Dove@bankfab.com

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