From West to East

Weekly Investment View
18th February, 2018

We are happy to have added to equities a week ago

Last week the bell-weather S&P500 index closed up an exceptionally strong 4.30% for the week, leaving it 2.19% ahead for the year-to-date, with investors apparently brushing aside earlier concerns regarding higher US inflation and interest rate increases – which had just been the excuse for the worst week in two years. The S&P now stands 4.90% below its January closing all-time high (i.e. out of so-called 'correction' territory of 10% down), the intra-day low point having been 12% lower). While it was the case that the US CPI for January came in above expectations at the headline and 'core' levels, market participants perhaps determined that in the short-term the US equity sell-off had simply gone too far – as had weakness in the US dollar - and that it was time to flatten short positions, and/or for investors to buy. Lower US retail sales for January also partially offset the CPI numbers in terms of sentiment, plus it was of course taken positively that - at least so far - the Mueller investigation had indicted thirteen Russians, rather than members of Trump's 2016 presidential campaign team. Global equities as measured by the MSCI World index rose by 4.33% over the week, taking their cue from the US. Readers will remember that immediately prior to this rally the FAB Asset Allocation Committee decisively added to its model overweight positions in global equities, including taking emerging market equities up from neutral. **The VIX volatility index closed at 19.46 (down from the 29.06 of the previous week), as we and others had hoped it would (i.e. back within a more normal 15-20 range). It is this technical factor, perhaps more than almost any other that is likely to tempt genuine medium-to-long term investors back into the markets.**

"The US 10-year yield above 2.90% could be too far, too fast"

European equities as represented by the STOXX Europe 600 index closed 3.26% higher, possibly held down slightly by a stronger euro/dollar currency pair, while Japanese equities as measured by the TOPIX index closed just 0.31% firmer, much more definitely being held back by a strengthening yen impacting its important export sector. In bond markets, worries had already existed about the possibility of firmer US inflation (after the 2.9% year-on-year wage growth contained in the non-farm payrolls for January), with bond prices already notably weaker ahead of the CPI report. From a high of just above 2.9440% intra-day, the yield on the US 10-year Treasury closed at 2.8749%, up just over two basis points over the week. In FX markets, the dollar closed 1.48% weaker on its index (DXY), at 89.100 (after an intra-day low of close to 88.24). The dollar lost a further 2.38% vs. the yen, to ¥106.21, despite the announcement that Mr Kuroda would serve another five-year term as Governor of the Bank of Japan. While there has been talk that BoJ monetary policy may become less dovish, the yen/dollar pair currently appears to be driven by technical considerations. Oil markets bounced from what was probably an oversold position the previous week (with Brent at $64.84), yet with some increase in concern regarding non-OPEC production, especially from the US shale producers. **Gold took comfort from dollar weakness over the week as a whole, closing 2.30% firmer, at $1,346.96, although it is still in an overall bearish trend in euros.**

"The Federal Reserve trusts the PCE inflation data, not last week's"

US consumer price data for January released by the Labor Department came in at 0.5% last month, vs. expectations for an increase of 0.3%. Excluding food and energy prices ('core'), the increase was 0.3%, compared to expectations of 0.2%. Price pressures were said to have been quite broad, although with apparel particularly mentioned (up 1.7% month-on-month); the headline number was 2.1% higher year-on-year, vs. expectations of 1.9%, while the 'core' was unchanged year-on-year, at 1.8%, compared to expectations of 1.7%. However, the Federal Reserve uses the Commerce Department's PCE (price consumption expenditure) data series, which has different weights (with less emphasis on housing costs) within a broader basket, and which is said to adjust more quickly to changing spending patterns based on relative prices. The PCE data was (in December) running 0.3% point year-on-year below the Labor Department data, and the Fed do presumably have good reasons for preferring it. In other data, the University of Michigan Consumer Sentiment Index came in at a healthy 99.9 for February, up from 95.7 in January, although retail sales fell in January by 0.3% (vs. expectations for an increase of 0.2%), recording their biggest drop in nearly a year, as households bought fewer motor vehicles and spent less on building materials. Also, December data was revised to show sales unchanged, rather than increasing 0.4% as previously reported. Retail sales in January were 3.6% from a year ago. US retail sales are an especially volatile dataset, as evidenced by this month's prior revisions. **The latest reading from the Federal Reserve Bank of New York's 'Nowcast' for annualized growth for the current quarter stands at 3.11%, which seems a fair estimate to us.**

"The Central London prime residential real estate market has probably bottomed"

Turning to UK real estate, we have just analyzed the latest quarterly report from Knight Frank, our leading UK real estate counterparty. They began by noting that UK Treasury forecasts now suggest consumer spending growth of 0.9% in the current year, a reduction from 2017's 1.5% estimate, and indicative of slackening growth. However, looking back to the second half of last year, Knight Frank were rather more optimistic than their UK real estate forecasting peers, yet were happy to be away from the pack. **Heading into 2018 it appears they were correct in their overall view, and that – for instance in highly visible Central London prime residential – the market is recovering.** Naturally our partners have covered themselves by reference to the possible risks that still exist in the UK (politically, mainly), and probably wisely make no reference to the value of sterling. As strategists - and with an underlying interest in UK real estate - we would observe that Knight Frank's attention to the level of supply and the nature of it across the sub-classes - rather than getting caught up in pure market sentiment - has enabled them to successfully read their markets. Accordingly we would under-line their comment that as 2018 unfolds the consensus view on the outlook for UK real estate remains more defensive than they believe is warranted. They add that from overseas investors to domestic funds and listed vehicles, they don't expect any shortage of capital to target direct property purchases in the UK. It is a fairly densely-populated country, and quality land remains in short supply. We would add that those who still want to buy that so-called '*des res*' in London (or elsewhere in the UK) may not have missed the boat. The near-term outlook for sterling may continue to be volatile, certainly, due to either Brexit, or the political tribulations of Mrs. May, the UK Prime Minister. **The chances are that those buying prime real estate in London (the '8th Emirate') now, or in the near-term (maybe with the help of sterling downside), will be very glad they did so in a few years' time, once Brexit is history.**

"The correction we suggested would arrive did so"

INVESTMENT SUMMARY: The Trump Administration early last week proposed taking an additional decade to balance the US budget, coincident with publishing a spending plan that - as we know – assumes that higher realized economic growth will ultimately help to pay for the tax cuts recently announced. The $4.4 trillion proposal for fiscal 2019 includes $200 billion of infrastructure spending over the next decade, and we note that on average the kind of spending being put forward usually produces good 'multiplier' effects. Market concerns regarding how all this (or a portion of it) can be financed and the resulting effect on total US government debt has been impacting the US dollar. We are more optimistic than many on US, and global, growth. Meanwhile, the swaps market suggests Fed funds at 2.45% in February, 2020, vs. an effective rate of 1.42% today (i.e. the market discounts four hikes by then). Last November (at 1.92%) we said the market was behind the curve. It probably still is, but now by only one hike (maximum two), none of which should lastingly damage equities – at least not quality equities with low debt. **The FAB Asset Allocation Committee is overweight in global equities (almost across the board on a regional basis), overall neutral in global bonds, and quite heavily underweight in cash and alternatives (hedge funds); the Committee meets later this week and although happy with most of its expectations will attempt to fine-tune several of them.**

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