Staying overweight in global equities

The S&P500 closed 0.55% higher for the week in a very bullish Friday reversal from the bearish sentiment of earlier in the week related to interest rate expectations. There had been no shortage of commentators talking the market down, mainly relying on the extrapolation of a short-term up-trend in market rates that was already looking somewhat overdone, especially at the short end of the curve. Concern had been mounting that US inflation was going to take off, and that higher rates would be needed over-and-above what the market has already been discounting. In a 'data-light' week, probably the most important item on the agenda was the publication of the US Federal Reserve's minutes from its January monetary policy meeting – which in the end was treated as old news. For most of the week market participants' attention was firmly on the yield on the US 10-year Treasury bond, whose yield traded above 2.95% intra-day at one stage. The S&P rose 1.48% on Friday, with US equities as a class driven by a combination of large up-moves in the likes of Hewlett-Packard Enterprises (+10.4%, after estimate-beating results and positive guidance), Nordstrom, Intel Corp, and Microsoft, these being the largest gainers. In other markets, the STOXX Europe 600 index closed the week up 0.14%, ahead of the firmness in US equities. Japan's TOPIX index closed the week 1.33% ahead, probably partly due to relief that the yen's strength was appearing to run out of steam. **Elsewhere in Asia, China returned from the Lunar New Year break, with the CSI 300 index regaining the 4,000 level, and hence once again trading above its rising 144-day moving average.**

"A breach of 3% on the US 10-year Treasury yield was almost universally called for"

In global bonds, the Bloomberg Barclays Global-Aggregate Total Return index (unhedged) fell by 0.43% over the week (to 487.5038). Late during US trading hours on Friday the 10-year Treasury yield tracked off quite sharply, to close marginally lower over the week, to 2.8660% - which was just over nine basis points below the high reached after the release of the Fed minutes. **There was also interest in the minutes from the ECB's recent meeting, almost certainly contributing to a fall in the yield on the German 10-year Bund of just over five basis points (to 0.653%); the market interpretation was that the ECB would not hesitate to bring back QE in larger amounts in the event that it ever thought it necessary to do so.**

"The strength of the MSCI Emerging Market Currencies index is about EM strength, not just dollar weakness"

In foreign exchange markets, the main event - aligned with the US 10-year yield not immediately blasting through the 3% level - was again something that did *not* immediately occur .i.e. calls for the dollar index (DXY) to continue its fall below the 88.671 closing level, with the move accelerating along the way. The DXY closed up 0.88% over the week, at 89.883. The rise in US dollar yields (and rate differentials) at the shorter end (where the 2-year US Treasury yield closed almost five basis points higher), finally seemed to take effect; with commentators noting the weakness in the dollar despite rising US short rates, the tipping point needed to counteract Trump negatives has probably been reached. While proposed stimulatory US economic policy (tax reform and the rest) has been a guiding light to global equities, investors have also become much more aware that there are other growth and recovery points in the world – witness for instance the almost 22% rise in the MSCI Emerging Markets Currency index since early 2016 – before the DXY peaked at the end of 2016 i.e. – this is not simply about dollar weakness. In truth the dollar has faced genuine competition from other currencies, outside the other major reserve currencies - and this now includes the Chinese renminbi. Coming back to dollar-specific factors, we have in recent weeks noted increasing market concern about a growing US budget deficit (in addition to the existing trade deficit), as well as the likelihood that the Trump Administration is increasingly prepared to allow the dollar to weaken, to support exports and the translation of foreign earnings into a greater number of dollars. The euro/dollar pair last week corrected by 0.89%, to $1.2295, yet speculative positioning against the dollar (via the market's favourite route, the euro) is described as being very heavy. We still have difficulty regarding the yen as a 'haven', so welcome even the small rally in the dollar vs. the yen to 106.89, up from the 106.21 of the previous week. Sterling closed at $1.3971, 0.39% lower over the week, not helped by new aggressive statements from European Commission president, Donald Tusk, to the effect that the UK will be unable to 'cherry-pick' a trade deal with the EU during the final phase of Brexit. Sterling's risk appears to be to the downside to us, as we believe a whole new nastier phase of negotiations is beginning to unfold. British Prime Minister, Theresa May is coming under growing political pressure from within her party to take the 'hard Brexit' route, possibly withholding the financial divorce settlement payment already agreed unless it secures an acceptable overall trade deal. In commodities, Brent crude rose by 3.81%, to $67.31/barrel, mainly helped by data from the

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US Energy Information Administration showing that US crude inventories fell last week when a rise had been expected. **Gold fell by 1.35% over the week, and only 'disaster hedge' positions appear justified.**

"In reality January's FOMC minutes contained very little new for markets"

The Fed minutes for the 30th-31st January meeting as portrayed by commentators suggested a growing sense of confidence among FOMC members regarding the outlook for the US economy and inflation. This in turn led to the initial conclusion that the US central bank might raise rates and tighten policy more aggressively than expected - with a growing number of strategists wondering whether we should expect four hikes this year, rather than the already-prescribed three. The minutes recorded that, "Beyond 2017, the forecast for real GDP growth was revised up, reflecting a reassessment of the recently enacted tax cuts, along with higher projected paths for equity prices… and foreign economic growth, and a lower assumed path for the foreign exchange value of the dollar". They went on to say that "…core PCE prices were forecast to rise notably faster in 2018", although: "Core inflation would reach 2% in 2018". The most recent reading for this was 1.5% year-on-year in December. Thinking back to the statement following the meeting, much fuss had been made of the addition of the word 'further' in relation to expected rate increases, yet last week we saw FOMC member Neel Kashkari's interpretation of this, which made sense, in which he explained that the use of the word 'further' referred to the interest rate path they are already on (rather than extra hikes over and above what had already been projected). **We would also repeat that wage gains in US sectors cannot automatically be translated into higher posted prices for goods and services, and that "Digitization, and increased productivity through sustained innovation should continue to keep global inflation in check." (FAB Global Investment Outlook 2018).**

"Italians go to the polls on 4th March – with a tradition of coalitions unlikely to be broken"

On the 4th March, Italian voters will be going to the polls in a general election. To outsiders, Italian politics is a highly complex affair, and this is our attempt to provide a very brief guide ahead of the vote. By this time next week we should know much more about the state of the alliances. We would note that Italy has had 64 governments and many prime ministers since the Second World War. There is even the possibility that Silvio Berlusconi (he leads the Forza Italia party) could make a comeback, as in reality he is quite popular at ground level. How the various coalitions pan-out will determine what the landscape will look like. The main parties are as follows: Forza Italia (center-right), the Democratic Party (PD), and the anti-establishment '5 Star Movement' (M5S). Informed observers point out that most of the parties have moderated their stance towards exiting the EU. Meanwhile, a new electoral law favours coalition governments, which will help perpetuate this moderating factor. As far as we can tell at this stage, the opinion polls don't point to a clear winner, either by party or by coalition. Nothing whatsoever can be taken for granted. Having said that, a 'grand coalition' led by PD and Forza Italia could look to be one of the most likely outcomes. A coalition government led by M5S has not featured with a high probability in our reading. A genuinely 'hung parliament' would lead to new elections. We will revisit developments in next week's report, but at this stage cannot identify a likely eventuality that would be a great danger to the Eurozone, with 'more of the same' expected. **However, we should note that perhaps 30% of voters remain undecided.**

"The FAB Asset Allocation Committee essentially left policy unchanged – although might add a tactical position in G3 Government bonds"

INVESTMENT SUMMARY: The FAB Asset Allocation Committee ('AAC') met late last week, and was essentially happy with current investment policy, however was due to vote on a purely tactical basis to overweight G3 Government bonds/Investment Grade. This was on the view that the review of all the AAC's investment metrics was consistent with the upper limit of 3% on the US 10-year Treasury yield not giving way in the short-term, and a pull-back in this - perhaps to the 2.60% level – appeared quite likely. The swaps market discounts four to five Fed rate hikes in the next two years, and while this could perhaps be exceeded by one, the system (and investors) could cope with this (the exception being highly leveraged entities). Trump will have trouble getting all his spending initiatives through, so although the US budget deficit will grow, we expect good, measured growth in a framework that has sensible checks and balances. The S&P500 is trading on a very moderate P/E ratio of only 16.0 x for the current year, which is slated to fall to 14.5 x for 2019, based on conservative earnings growth of 10.4% and 10.1% respectively. **The AAC underlined that it remains committed to its overweight position in global equities.**

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