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FAB

First Abu Dhabi Bank

From West to East

Weekly Investment View

21st January, 2018

As in 2013, the US government shutdown will pass

US equity investors almost totally ignored the possibility of a US government shutdown - which now looks highly likely to occur unless talks taking place this weekend are able to avert it at the eleventh hour - with the S&P500 closing last week at yet another all-time high, its 10th record closing high of 2018. The US House of Representatives had passed a stop-gap measure on Thursday to keep Federal agencies funded until 19th February, but Senate Democrats and a few Republicans wouldn't agree to the deal voted upon after Friday's market close. The S&P rose 0.86% over the week, to 2,810.30, ahead by 5.11% for the year-to-date, as investors continued to focus on a positive outlook for US economic growth (and elsewhere, with good official growth numbers out of China for last year), and overall improving corporate earnings. The NASDAQ Composite index also closed at a fresh record. The STOXX Europe 600 index closed 0.60% firmer over the week, at 400.88, with its technical picture looking very encouraging. In economic statistics, first-time claims for US unemployment benefits continued to fall, to the lowest level in nearly 45 years for the week ending 13th January; the report said initial jobless claims fell to 220,000, a reduction of 41,000 from the previous week's 261,000. In other US economic news, the Fed's 'Beige Book' said the outlook for the US economy in 2018 "remains optimistic for a majority of contacts across the country". Chinese economic growth for 2017 came in above expectations, at 6.9%, leading to an immediately positive response from Asian stocks on Friday. **Our favoured MSCI Asia-Pacific (ex-Japan) index closed 1.46% higher over the week, matching the S&P, at +5.12% for the year-to-date.**

"Higher bond yields are a long way from hurting equities – especially given better (but not explosive) economic growth"

In bond markets the US 10-year Treasury yield closed at 2.6592%, up a meaningful 11 basis points over the week, and closing above the 2.60% level deemed to open the door to an eventual test of 3.00%. In the FAB Global Investment Outlook 2018 we recently increased the upper boundary of our target range from 2.60% to 3.00% for the current year, based mainly on our perception of underlying US economic growth and the continuation of the Fed 'normalization' cycle. Last week also saw more public discussion (led by Federal Reserve of New York Governor, William Dudley) suggesting the Federal Reserve should explore moderating its 2% inflation target i.e. the non-attainment of this level should not hold back monetary tightening. In other markets the yield on the German 10-year Bund closed at 0.5680% (vs. 0.5810% the previous week); purely technically it can be said that 0.50% on this bond is equivalent in terms of market sentiment to 2.60% on the US 10-year yield. In foreign exchange markets, concern about a US government shutdown had already been weighing on the dollar, with the recently rising US 2-year Treasury yield (at 2.0647%, 6.7 basis points firmer over the week) not being sufficient to make the US dollar more attractive in last week's market; the dollar closed 0.44% lower on its index, at 90.572. The euro/dollar pair closed at $1.2222, static over the week, with some market participants expecting the ECB to adopt more hawkish tones after its policy meeting next week (we disagree, as the ECB will now be concerned that a euro that rises further could endanger Eurozone export competitiveness). Also, we note that Mrs Merkel's coalition deal is not yet done; as we go to print Germany's Social Democratic Party (SPD) is asking its 600 delegates whether the party should indeed begin full coalition negotiations. **Lastly, in Asian FX markets it is worth mentioning that the recent strength of the Chinese renminbi (both onshore and offshore) has been sustained towards 6.40 per US dollar, its strongest since late 2015.**

"We may have to revisit the $70/barrel upper limit assumption in the months to come"

In crude oil markets, Brent closed at $68.61/barrel, 1.80% lower over the week, although holding at the higher end of our anticipated $50-70 range. Last week OPEC said it now expects non-OPEC supply to grow faster this year than previously, especially in the US, Canada, Mexico, and the UK. They expect the increase in US shale output to be 110,000 barrels/day higher than previously, i.e. an extra 820,000 barrels/day. However this marginally bearish new expectation was countered by a continued fall in US crude oil inventories, which fell by 6.9 million barrels (to 412.7 million) during the week ending 12th January, for the ninth drawdown in a row – and despite rising crude imports. **Elsewhere in commodities, gold closed at $1,331.84/oz, just under half a percent lower over the week, despite the lower dollar and the possibility of the US government shutdown. Gold expressed in euros has remained in the bearish mode established during the second half of last year.**

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"An extended US government shutdown would hurt both Democrats and Republicans"

Leading up to last Friday night's vote in the Senate, the Republicans had been trying to keep a dispute over immigration separate from their efforts to reach agreement on spending priorities. There is a sense that both parties are willing to face-off against each other over their underlying policy differences, and if necessary allow the government to shut down in the process. The last government shutdown, for 16 days in 2013, ended up knocking 0.3% off US GDP growth that year. If no deal is reached this weekend and the required 60 Senate votes do not materialize, about 750,000 non-essential government workers will be 'furloughed' (lay-off without pay). Senate voters against the budget deal said it failed to "balance spending", and that continuing negotiations would be needed into February. Senate Democrat leader, Chuck Schumer, visited the President at the White House but they failed to agree a way forward. A few Republicans joined Democrats thus blocking short-term funding for government agencies, with the vote at 50-48 against the motion. Democrats want the bill to include protection for around 700,000 undocumented immigrants who came to the country as children (so-called 'Dreamers'). When Congress last month passed the short-term bill to keep the government open until 19th January the hope that been that a deal on immigration would have been reached by then. **In the meantime, it remains to be seen whether investors will blink – i.e. will they continue to regard a US government shutdown as a temporary phenomenon which must surely end soon – and which provides a buying opportunity in a market which has been almost singularly devoid of them? Certainly the US economy is in much better shape than in 2013, and could arguably withstand such a stand-off provided nothing else untoward happens.**

"The Chinese GDP numbers need more analysis – but allow more time to resolve domestic economic issues"

Moving to last week's announcement of Chinese GDP growth for 2017, it was once again proven that economists' forecasts were not optimistic enough. In fact, Premier Li Keqiang had apparently said earlier this month that 2017 growth had been about 6.9%, by reference to better-than-expected exports, government revenue, corporate earnings and domestic income. According to official data, China's economy grew by 6.9% last year, above Beijing's official target of 'about' 6.5%. Of course many market participants remain skeptical regarding such data. Last week's numbers showed that in the final quarter of 2017 the economy grew at an annual rate of 6.8%, higher than expectations. While we will be looking into the figures in greater detail in the days to come, in the meantime it appears that an export recovery helped the result, more than offsetting the effects of the self-imposed credit squeeze seen last year and designed to clean up and de-leverage various aspects of the Chinese economy. **In commentary released a few days before this growth data, Moody's suggested that China's 'hard-landing' scenario had become "more remote".**

"We remain firmly bullish of equities – but as foreshadowed expect more volatility"

INVESTMENT SUMMARY: In terms of our continued risk-on stance in equities, although we are only a few weeks into 2018 this is looking good, and especially regarding the 'tilt' towards Asia-Pacific (ex-Japan) equities. As mentioned last week, the Asset Allocation Committee in fact extended its bullish view to Japanese equities.

Turning to US politics, it has been clear that the Republican's wafer-thin majority in the Senate is a problem, and the shutdown is clearly a manifestation of this, and it may well be a recurrent theme. Even so, we believed towards the end of last year that the US Congress would vote tax reform through, and the substantial benefits of that should begin to accrue in the months to come. So our views haven't changed. Various aspects of introducing an easier regulatory environment in the US only need President Trump's signature, not votes in Congress. Regarding the dollar, some would say it's a brave investor who would favour the dollar at current levels, yet we do, as we believe the US dollar has now (at 90.572 on the dollar index) over-discounted much of the worst – and that volatile politics shouldn't spoil the excellent global economic backdrop we now believe is in place in the US, and rippling across much of the world. **Our investment policy remains unchanged.**

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