From West to East

Weekly Investment View
28th January, 2018

Good news: World growth is revised upwards by the IMF

The S&P500 and other US stock indices closed yet again at new all-time highs - the S&P was 2.23% higher over the week – driven by a combination of good corporate results, and further US dollar weakness. The dollar closed at 89.067 on its index, 1.66% lower on the week, with commentators saying they were confused by views expressed firstly by US Treasury Secretary Mnuchin and then President Trump on the currency at Davos. With the dollar index close to a three-year low it closed 2.1% below the lower limit of the range we had anticipated for 2018 i.e. the 91 level. The renewed fall earlier in the week appeared to be triggered by the US imposing tariffs on solar panels (surely a long time in coming) and on washing machines, with these moves being - arguably prematurely - extrapolated into a new trade war by commentators. In other news, US fourth quarter GDP came in at an annualized 2.6%, with an inventory adjustment causing this to come in below the 3.0% headline figure expected. **Elsewhere, Brent crude closed above the 'roundaphobic' $70/barrel level (at $70.52), up 2.78% over the week.**

"Trump's performance in Tuesday's State of the Union will be key"

The rise in US equities is all well and good, and in line with our bullish view for 2018, although it would certainly be healthy to see a correction. Estimated earnings for 2019 rose further last week, to 187.46, for a P/E ratio of a still-moderate 15.3x for that year. The VIX index (derived from market estimates of volatility on a range of S&P stock options) closed at a seemingly rock-solid 11.08 (vs. an average of about 15 historically), and based on trading volumes in underlying equities only in line with averages over the last three years or so. So investors still look to be 'buying the dips' on balance, yet (with an eye on the Bollinger Band measure) equity prices are rising so steadily that one cannot say they are technically overbought – yes, they are well up into the upper half, although not currently beyond the upper boundary itself. Fundamentally, stocks could still be just over 10% 'cheap', provided bond yields stay below about 3.50% on the US 10-year during the next 18 months or so. During such an almost idyllic period we are still hoping for that elusive correction – and the latter could be delivered by the next dollar rally (prompting profit-taking), the next adverse US Senate vote for the Republicans, or something more unpredictable. Unless the 'something unpredictable' turned out to be a genuine game-changer – or much more of a 'melt-up' resulted in high valuations - we are likely to remain solidly bullish of US equities. **In the very short-term, it's possible Trump may do badly in his first State of the Union address this Tuesday night – yet his measured performance at Davos suggests otherwise, and he is still basking in his huge win last month in tax reform.**

"The euro and yen have reached levels from which they need to correct – for the sake of earnings"

We remain keen on European equities, helped last week by a good business update from LVMH. Having said that, we were not surprised to see the asset class as a group held back by Euro strength (and UK equities were similarly been held back by the firmness in sterling). The STOXX Europe 600 index fell fractionally over the week. In the same way, Japan's TOPIX index was held back, with the firmer yen being the main driver behind a 0.55% fall over the week. **So in these sub-equity classes currency realities have begun to cause slight concern.**

"Bell-weather bond yields are edging upwards"

Turning to bond markets, the bell-weather yield on the US 10-year Treasury was almost unchanged over the week, holding at just below 2.66%. However the yield on the 2-year Treasury note rose by just over five basis points (to 2.1163%), about a nine-year high. So on the face of it bond investors weren't affected by the moderate top-line miss in US fourth quarter GDP, with expectations registering still-optimistic views for US economic growth later this year and into 2019 as multiplier effects from tax reform begin to ripple through the economy. The German 10-year bund yield rose just over six basis points, to 0.629%, thus maintaining the momentum of the breakout above the 0.50% level earlier this month. The Bank of Japan (BoJ) kept its monetary policy unchanged last week, with short- and long-term interest rate targets at -0.1% and 0%, respectively. **Accordingly the Japanese Government 10-year bond yield traded down, closing the week at 0.078% (vs. 0.085% the previous week).**

"Yen strength is what we especially noted in FX last week"

In foreign exchange markets, following on from the introductory paragraph, the US dollar saw weakness to levels that begin the ask important fundamental questions about whether a new, lower trading range or channel is likely. We are not yet saying this is the case (vs. our recent call for a 91-100 trading range for the current year), although in the days to follow the Asset Allocation Committee will certainly reassess the evidence, especially the fundamentals, rather than technical/chartist interpretations (most of which look bearish). The Euro closed at $1.2427 last week, after a high of above $1.2600 the previous day. What has really made us sit up and take notice has been the short-term bullish trend in even the Japanese yen; while Japan is economically benefiting from the 'rising tide that lifts all boats' in our favoured Asia-Pacific region, given the government's debt burden - most of which is held externally – and its reliance upon exports, if there was ever a country that needed to win the 'currency deprecation war' between developed nations, Japan is surely the one. Strengthening in the yen much below the ¥108 level on a two-day close would probably bring the ¥100 level into focus (and this is a genuine chart support point, not just sheer roundaphobia). **Remarks from Bank of Japan Governor Kuroda last week suggesting he was more optimistic about them finally achieving their 2% inflation target appear to have added to yen firmness, while we presume international investors are still accumulating Japanese equities in their desire to play 'catch-up' vs. other markets.**

"Sterling has seen considerable short-covering"

Lastly, in FX, sterling briefly climbed above $1.43 last week, closing at $1.4160, due to short-covering prompted by a small beat in fourth quarter GDP (0.5% sequentially, vs. expectations of 0.4%), a pick-up in wage inflation, and perceived improving Brexit negotiations. So market participants presumably eyed more 'normalization' in the future, and a return to the historic higher interest rate structure in an economy still capable of generating inflation (especially 'cost-push' in nature). Our Global Market colleagues have penciled-in $1.50 on a 12-month view. **We are not sure we agree with that just yet, being mindful of the political risks that remain in that (a) the European Commission must not let Brexit look easy, and (b) Mrs. May and her Conservative Party are not out of the woods yet.**

"Oil may not be fully capped at $70/ barrel by higher US shale-based production"

In oil, Brent was firmer over the week as mentioned, closing marginally above the top-end of our forecast range ($70). Many hedge funds have got quite long in recent weeks, and while US inventories have been falling for a number of weeks in a row, this kind of price is that at which US shale-based production could be expected to get ramped-up – and that is what appears to be happening, with the Baker Hughes Crude Oil rig count beginning to tick upwards (to 759 rigs for the week ending 26th January. This is perhaps another instance where we need to always continually question our assumptions. It may well be that global oil demand could be better than we have been expecting, and the market is re-balancing at a slightly faster rate. **In gold, the dollar price was $17.28 (or 1.30%) firmer over the week, although the price in euros (for instance) fell slightly, and the tell-tale signals in such metrics continue to suggest that investors indeed remain bullish of risks assets – and have little desire to add to gold weightings retained for hedging purposes.**

INVESTMENT SUMMARY: Early last week at Davos the IMF provided its usual GDP forecast update for the time of year, the bottom line being that they have revised their expectations for world growth upwards for the current year (from 3.7%, to 3.9%), and similarly for 2019 (also from 3.7% to 3.9%). Within this, to reflect the perceived benefits of US tax reform they increased their forecast for the US by 0.4%, from 2.3% to 2.7%, and from 1.9% to 2.5% for 2019. Japan clearly needed to be increased for 2018, and was upped by 0.5%, to 1.2%. China was nudged upwards by 0.1% for this year and next, to 6.6% and 6.4% for 2018 and 2019 respectively. In our Outlook 2018 we had been assuming 4.0% (we thought, quite bullishly) for global growth for the current year. The underlying thesis of better global growth is probably one of the most supportive underlying assumptions for our 'risk-on' stance in equities. We had said the same thing at this time last year, and once again we expected these baseline IMF GDP forecasts to be edged upwards throughout the current year. However, we are now thinking we may have been a bit too cautious (especially on China – at least in terms of the stated official growth number), while we believe there is still some room for better US growth in the US than the IMF is expecting. **Yes, rates will continue to be normalized, but because we don't expect either growth or inflation to really take off we don't expect interest rates to particularly damage equity values.**

"Mnuchin was correct in his dollar comment – and probably so was Trump!"

At Davos this week, after commentators had drawn bearish conclusions for the dollar from the few tariff moves announced, US Treasury Secretary Mnuchin did his best to calm the markets by pointing out the advantages of a lower dollar to the US economy. He strikes us as an especially clever individual, and being steeped in markets for most of his career he made that comment – which was followed by Trump making more of a longer-term observation that the dollar should strengthen as higher growth takes hold. So in a real sense they are both correct – but in the meantime commentators have had fun pitting one comment against the other, with the US currency caught uncomfortably in the middle. Also, President made the comment separately that any growth that the US achieved would of course be good for many other economies. We don't believe a major global trade war is imminent. For instance, the US may have withdrawn from the Trans-Pacific Partnership, but those remaining have re-grouped forces and will almost certainly do more trade between themselves in the future. **Elsewhere, the other major bull market globally is probably the number of bilateral trade deals being worked upon – bullish for world growth.**

"Asset Allocation remains unchanged – but we are watchful of our expected trading ranges"

Lastly, the Asset Allocation Committee met last week, and decided not to make any changes to the model portfolios. Investment strategy remains unchanged, and as reflected in the FAB Global Investment Outlook 2018.

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