Side-stepping some summer equity risks

Last week the US Federal Reserve left rates on hold at 1.75-2.00% (as expected), the US non-farm payrolls (NFP) and wage growth came in below expectations (but a revision in the prior month offset disappointment with the headline payroll number), initial US-China trade talks in Beijing ended inconclusively, and a few emerging market currencies (the Argentinian peso and Turkish lira) saw marked downside. The S&P 500 index ended strongly on Friday, recovering to only 0.25% lower over the week, with sentiment helped by Apple's numbers and the news that Berkshire Hathaway had added to its position since year-end. Otherwise the index would have been weighed down by trade concerns. Apple helped the NASDAQ Composite back to its winning ways, with that index closing 1.26% higher over the week (and technically intact). The STOXX Europe 600 index gained 0.62%, helped by the weaker euro, despite downbeat Eurozone economic data. Japan's TOPIX fell 0.33%, with the yen flat on the week. The MSCI All Country World Index, containing developed and emerging equity markets, closed 0.49% lower. In global bonds, the Bloomberg Barclays Global-Aggregate Index closed 0.35% lower, affected by emerging market bonds. In developed markets, the yield on the US 10-year Treasury edged lower over the week, to 2.9497%, with reaction to the NPFs being neutral; overblown expectations regarding an upside break of the 3.00-3.02% level continue to unwind. The US hourly earnings part of the NFP report (these grew by a below-consensus 2.6%, unchanged from March) was supportive of government bonds on Friday. **At the same time the Fed making its comment that its 2% inflation rate target wasn't 'symmetrical' kept traders from becoming bothered by the 'core' PCE inflation reaching 1.9% on a year-on-year basis.**

"Supply-side factors have insulated oil from a firmer dollar"

In contrast to the US, Eurozone core inflation fell to 0.7% in March (vs. 1.0% the previous month), underlining the predicament that the ECB finds itself in - and the monetary policy divergence between central banks. Eurozone retail sales and the services PMI also came in on the weak side. In FX markets, the dollar index rose for the third consecutive week by a further 1.12%, to 92.566, a new high for the year to date. The euro/dollar pair was 1.40% lower, at $1.1960, and sterling fell a further 1.81% (to $1.3531). The MSCI Emerging Markets Currency Index closed 0.59% lower over the week (at 1,685.82), dragged lower by the Argentinian peso and the Turkish lira. In commodities, Brent crude was slightly firmer, at $74.87/barrel, mainly thanks to OPEC production compliance being helped by weakening Venezuelan output and outages in Libya, deliveries out of key US shale areas being capped by pipeline shortages, plus expectations that the US will scrap the nuclear deal, to be confirmed next week. In crude, most of the price pressure has come from tight supply (rather than bullish demand), so a stronger dollar is much less of a price-dampener. **Dollar gold closed $9.5/oz lower (at $1,314.50), and stronger in euros.**

"The Fed said "gradual" twice, re: rate rises"

Looking at the NFPs in detail, these rose by 164,000 in April, 30,000 or so below expectations, but in practice this didn't matter as the March number was revised upwards by 32,000. The headline unemployment rate moved down to 3.9%, after six months at 4.1%, although mainly due to 410,000 workers dropping out of the workforce. The lack of wage gains continues to be an issue. Job gains have seen an average monthly gain of 191,000 over the last 12 months, and have averaged an even healthier 208,000 over the last three months. Earlier in the week the FOMC left the US Fed funds rate unchanged, as expected. Looking at the wording of their statement, we think the salient points are: **(1)** Since the March meeting the labor market has continued to strengthen and economic activity has been rising at a moderate rate; **(2)** The growth of household spending moderated from the strong Q4 rate; **(3)** business fixed investment continued to grow strongly; **(4)** On a year-on-year basis both headline and core inflation moved close to 2%, with measures of longer-term inflation expectations little changed (the two-year breakeven is at 2.10%); **(5)** the FOMC expects that, "with further gradual adjustments in the stance of monetary policy, economic activity will expand at a moderate pace in the medium term…" (we would underline 'gradual'); **(6)** "Inflation on a 12-month basis is expected to run near the Committee's symmetric 2% objective over the medium term"(so once again they allow for readings above and below 2% over time); **(7)** "The stance of monetary policy remains accommodative…", and **(8)** "The Committee expects economic conditions will evolve in a manner that will warrant further gradual increases in the federal funds rate; the federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run" (note the second use of the word 'gradual', re: rate increases, followed by to 'below levels expected in the long run'. **Unless there is an external shock or a significant policy error, what is there not to understand?**

"The EM world is not in crisis"

With the recent strengthening in the US dollar have come calls to beware of emerging market assets, for historical

reasons relating to the 2013 'taper tantrum' - but while there are still certain countries where investors have to be very careful, the EM world has made great progress since then. As the FT wrote a few days ago, "Among currencies, the biggest fallers have been the usual suspects… those with big current account deficits and other imbalances". The JPMorgan Emerging Markets Bond Index (Global Diversified Composite) fell by 1.26% last week, and is 4.30% lower for the year-to-date. Last week the US dollar rose by 6.45% against the Argentine peso, and by 4.66% against the Turkish lira. In the case of Argentina, which raised its rates by 15% last week to 40%, they clearly felt they had to defend its currency at all costs; this comes after a period when investors were hoping for reforms to have been more rapid, to correct structural imbalances created by the left-wing administrations of the past. In Turkey, inflation has risen sharply, with a recent rate rise having little effect so far, while in politics its presidential elections were brought forward by 17 months, to next month. We would emphasize these currency developments are specific developments, in an EM world that is far stronger overall than it used to be. In our Weekly of two weeks ago we advised investors to be sure to increase the average quality of their portfolios, across all asset classes. Although the EM world is trading more within its own boundaries these days, there are still pockets of risk, geopolitical and economic. The EMs (in our mind led by China, India and Indonesia, each highly prospective) are more in control of their own destinies than previously, but certainly the US is still a big influence. **However, we would rail against any views suggesting that the EM world is in crisis.**

"This is an exercise in risk control – with the clear intention of buying-back"

INVESTMENT SUMMARY: The FAB Asset Allocation Committee met late last week, and decided to take some money off the table in equities, by: (1) Reducing the overweight in North American Equities to just above neutral, retaining overweight positions in Information Technology and Financials; **(2)** Reducing the overweight in Asia Pacific (ex-Japan) Equities, but leaving this as a meaningful bet; **(3)** Reducing Emerging Market Equities to neutral, from overweight, and maintaining the overweight in India. The overweight positions in European and Japanese equities were left unchanged, the rationale being that short-term dollar strength/euro and Japanese yen weakness will be supportive in local price terms. The euro (and a portion of the yen) exposures are already hedged. All proceeds will be applied to cash. **The allocation to commodities and hedge funds remains very underweight.**

The Committee remains 'risk-on' for the medium-term, however, for 2018 as a whole, and into 2019. When members perceive downside risk to be growing this will be allowed for on a tactical basis. In terms of its direction, the vote to reduce equity risk was unanimous. For the year-to-date the MSCI All Country World Index is -0.82%, behind where we would have expected it to be this far into the year. There are sound reasons why the final quarter of 2018 should be very good in global equities, and we want to be well-positioned for this. The Committee is mindful of the lower trading volumes of the summer months, often causing any negatives to be magnified by more than just a few percent. We certainly don't believe the global equity bull market is over; rather, we expect it to be delayed for a few months or more. **Thereafter we would be looking for the kinds of excesses reminiscent of the last stages of bull markets - and which typically contain the best returns (after the majority of investors have already got out)!**

It appears to be a 'bearish divergence' that broad US equity indices have been unmoved, overall, by corporate earnings and revenue announcements coming in usefully above expectations. So the market is on its back foot, and more likely for the time being to be concerned about what might go wrong - although such concerns should lead to opportunities to put full long positions back on. Please consider the following (they are not in any particular order): **(1)** North Korea will not want to 'lose face', making sure the world knows any willingness to denuclearize is not the result of US pressure; **(2)** It has become very clear the Trump Administration has almost certainly decided to re-impose sanctions in its review of the nuclear deal, possibly causing oil to spike another $5 or so; **(3)** There has been a large US cut in corporate taxes, and while this should result in more capex, the fiscal gap has to be filled, so bond traders have begun to eye a 'break point' as auctions get larger and larger; **(4)** Trump has just repeated the threat of a Federal shutdown to get his border wall financed, and this was a major campaign pledge; **(5)** US-China trade talks ended inconclusively last week, with the US demanding a reduction of $200 billion in the trade deficit that it runs with China - so more commentators could say the trade war has actually begun; **(6)** The risks associated with Brexit appear to be growing; and **(7)** As we have signaled in recent weeks, the Republicans are facing more clear-cut risks as the US mid-term elections approach. **While these are just the 'knowable' risks, many of them will be resolved one way or another, in our view allowing the bull market in equities to resume before very long.**

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