More and more investment roads lead to China

US-China trade negotiations continue - and seem more hopeful

Brent crude is probably in a range of $65-90 for the rest of the year

The US 10-year Treasury yield may now consolidate above 3%

We are keeping the faith in Indian equities - and see INR as oversold

We continue to favour Chinese stocks - helped by index tracking

INVESTMENT SUMMARY: Our Asset Allocation Committee met last week, and left investment policy unchanged, the most recent actions having been to reduce global equity risk for the summer (lower volumes magnify adverse reactions). The equity bull market is expected to resume after a summer lull, and improve after the US mid-term elections. There could be a moderate correction in equities of 5-6% from current levels (i.e. not one worth selling for). We are watching to see if the US 10-year yield remains above approximately 3%; if so, we anticipate the new trading range could be about 3.00-3.32, with resistance at 3.50% above that. A yield of 3.12% (seen last week) is not a significant problem for equities. In the US dollar, bear positions (many vs. euros) are still being closed out, and central bank rate divergence is once again a driving factor. DXY index upside could be 95 or above as a first stop. In EM currencies, selectivity is key; the Chinese renminbi should be about the best bet (massive FX reserves, still very good growth, and anticipated inward portfolio flows). In Brent crude, the FAB Asset Allocation Committee increased its expected trading range to $65-90 (from $55-70 previously); in recent weeks we have emphasized political/supply-side risks (Venezuela, Libya, and also Iran), but expect KSA, Kuwait, and the UAE to augment US shale-based output in a market that is coming back into balance. **We agree with FAB Global Markets that a correction down to $65 (even $60) is possible if speculative positioning (which is quite extreme) gets unwound, and this would be a buying opportunity.**

Major events: (1) US and China trade talks are continuing in Washington. The rhetoric has been varied, but we believe there is now more hope that an overall settlement can be reached. Trump's surprise reversal of a ban on China's ZTE doing business in the US could have been a smart move on his part. The Chinese appear to have offered to buy more US goods, to move towards Trump's request that the US trade deficit with China gets reduced by $200 billion dollars. In Outlook 2018 we said FDI (foreign direct investment) would probably be used as a bargaining chip (as a counter to pure trade talks taking all the strain). **(2) North Korea have pulled out of planned talks with South Korea** (and hinted that those with Trump may be at risk), pending scheduled military exercises involving the US and South Korea. **(3) In Italy, an interesting political result is being delivered** .i.e. the anti-establishment Five Star Movement and the far-right League announced a deal to form a populist government. They have softened their original message on sovereign debt cancellation, although have retained a heavily anti-EU (and anti-euro) stance. **(4) Japan's economy contracted by an annualised 0.6% during Q1**, also, Q4 was revised to an annualized 0.6% (down from 1.6%). Q1 was worse than analyst expectations of a 0.2% decline, and the end of an eight-quarter run of growth. Analysts say this is not expected to be the start of a recession, mainly because the most important factor was corporate destocking, which usually reverses. **Certainly *if* there is no rebound in growth it makes any withdrawal of QE in Japan far more problematic.**

The Markets: Global equities closed 0.73% lower over the week, the result of various lingering uncertainties (trade, geopolitics), and not helped by the yield of the US 10-year Treasury breaking above 3%. The S&P500 closed 0.54% lower, although the STOXX Europe 600 index did rather better, 0.58% firmer (and was up eight weeks in a row), helped by the weaker euro. Japan's TOPIX was 1.13% to the good, led by a weaker yen. We delayed top-slicing overweight positions in Eurozone and Japanese equities expecting prices to rally on currency weakness vs. the dollar (while leaving FX hedges on), and that is what has happened. US small-and-mid- caps did well, with the Russell 2000 (the 2000 equities 'below' the Russell 1000) closing at a new all-time high. In bonds, the Bloomberg Barclays Global -Aggregate closed 1.09% lower, and close to testing its longer-term 377-day moving average. The US 10-year Treasury yield firmed by 8½ basis points, to 3.0559%, after 3.1261% intra-day earlier in the week. We wanted to see a two-day close above 3.02% before beginning to believe there is new, higher trading range in this bellweather yield. The higher US yields of last week reflect indications of improving US GDP growth, plus slightly higher inflation expectations, and a stronger dollar. Elsewhere in bonds, politics in Italy caused their 10-year sovereign bond yield to shoot almost 36 basis points higher over the week, to 2.229%. In FX, the US dollar was 1.19% higher on its index, at 93.637, a new high for the year-to-date. The euro closed at $1.1772, 1.43% lower on the week, while the dollar was 1.27% firmer vs. the yen. The MSCI Emerging Markets Currencies Index closed 1.31% lower, led by the usual suspects. In commodities, Brent crude closed 1.8% higher (at $78.51/ barrel), having traded above $80, intra-day. **Lastly, gold closed 2% lower on the week, at $1,293.04/oz, reflecting a higher dollar and higher rates - but arguably showing a relaxed attitude by investors regarding aggregate geopolitical tension.**

INDIA: A week ago after the Karnataka state elections, an interesting situation arose, an example of what can happen in Indian politics. The BJP (Prime Minister Modi's ruling Bharatiya Janata Party) won 104 of the 222 seats in the polls, but fell short of a majority by eight seats, 112 being the 'magic' number. However on the basis that the BJP were the single largest party, the state governor invited them to form a government, and allowed their candidate, BS Yeddyurappa, to become Chief Minister. This controversial decision - likely a violation of the constitution - led to a stand-off. The opposition Congress Party complained to the Supreme Court that the BJP lacked the necessary support, and the Court gave the BJP until Saturday evening to win over eight more members. The Chief Minister - in office less than three days - resigned minutes before a confidence vote, saying he could not secure the majority needed to form a government. Congress (the second largest party) then entered into an alliance with a regional party, Janata Dal (JDS), making a majority. The resulting coalition government will take over, and the swearing-in is this Wednesday. Had Congress lost in Karnataka it would have been a major setback for them, as they only rule three of India's 29 states. The BJP and its allies are in power in 21 states. Perhaps the most important takeaway from all this, however, is that popular sentiment for Mr. Modi's BJP has not declined as some had feared (the consensus expectation had been for the BJP to win 100 seats), and it raises the chances for them retaining a majority in the general elections due in 18 months. The BJP is in power across large parts of the country, however in Indian politics - seemingly like elsewhere - anything is possible in the several state elections due. It goes without saying that Mr. Modi must make sure he shows he cares about voters in rural areas. On a macro basis, the oil price is clearly an important factor; if we are correct that oil should only go as high as about $90/barrel (and then only on a short-term spike), then that negative could be contained. **Despite inflation coming in above the consensus estimate a week ago, and in the face of recent INR downside (to 68.01 currently), we are remaining with an overweight position in Indian equities, which we believe remain a very exciting medium-to-long term investment story.**

Lastly:

(1) Brexit: The UK Prime Minister has conceded that the whole of the UK could remain tied to a customs union with the EU after 2021 until an alternative to having a hard border in Ireland can be found. It is now almost two years since the Brexit vote took place, and it's been very hard-going - and with Mrs. May continuing to be under extreme pressure. **Time is running out.**

(2) China 'A' shares inclusion in MSCI Emerging Markets Index: On 1st June, MSCI will add more than 200 onshore listed Chinese 'A' shares to an important benchmark equity index used for the tracking of $12 trillion (Bloomberg). This is significant for China, which has waited years for a fairer representation of its financial markets in global indices (it also wants the renminbi to be internationalized). We have for many months argued that irrespective of debt fears and so on, many global investors would come under growing pressure to invest more in Chinese stocks. The initial weighting is very small (just 0.7%), but this figure should steadily grow as the Chinese authorities tick more of the boxes of global investors. This move is expected to lead to an initial $17 billion or so in passive funds entering the world's second-biggest equity market, with much greater amounts possible over time. **We retain an overweight position in Chinese equities in our asset allocation models.**

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