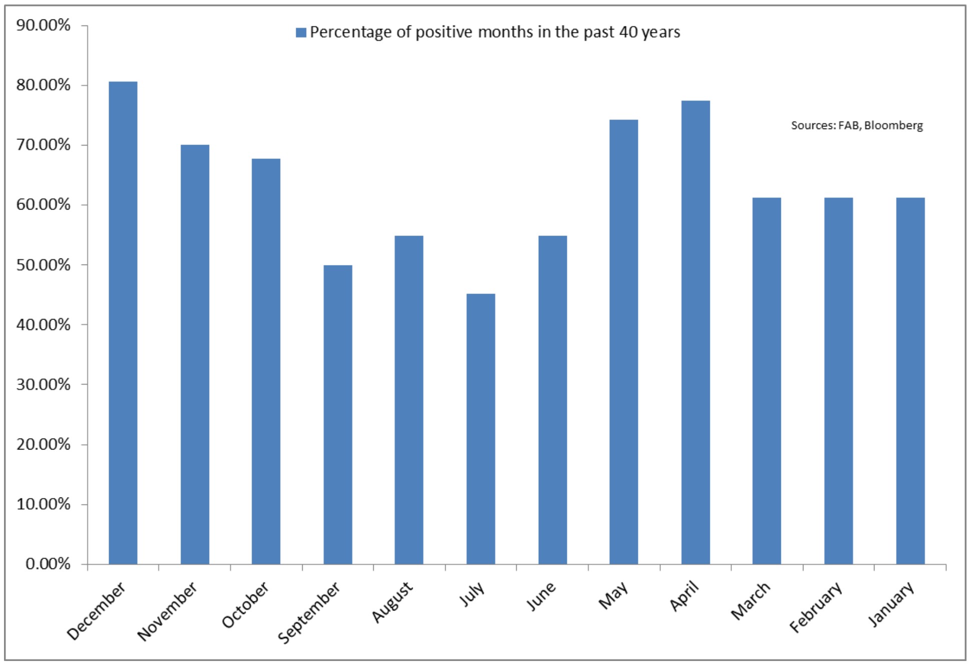
From West to East

Weekly Investment View
4th November, 2018

If history is a guide, the year-end could be good for US stocks

It really could not have been any different. It would have been rare for the US stock market to perform poorly for a long period when economic growth was very strong. Last week, what seems like a relief rally began to shape up, one that could pick-up speed once the US midterm elections this Tuesday are out of the way.

"Almost regardless of the outcome in the polls, investors are likely to return to US stocks, which have now became cheap enough to provide a buying opportunity."



If, however, Republicans achieve a surprise overall win in the House of Representatives, the ensuing rally could be dizzying. That, though, is unlikely. Throughout American history, almost every time the US President and his party dominated the White House and Congress simultaneously, they lost control of at least one of the legislative houses in midterm elections. Hence, if the House of Representatives ends up in Democratic hands, as is expected, this would only confirm history. That outcome is most likely priced into the market, however, and is unlikely to cause another drop in US stocks. There is the possibility of Republicans losing the Senate together with the House, but current opinion polls in the few highly contested states suggest the right-wing party will retain its majority in the Upper House. Hence, the only probable surprise at this point is if Republicans instead keep the House.

In fact, the market action in October was so bad that the amount of bad news priced into US stocks seems to far outweigh the actual headlines. Which helps explain why the FAB Asset Allocation Committee (FAB AAC) made a decision early last week to increase its overweight in US equities. The week before, the US Bureau of Economic Analysis had reported the US had grown 3.5% in the third quarter, slower than the 4.2% of the second quarter but still the fastest pace since 2015. Most important, the unemployment rate continues to hover near the lowest in half a century, having come in at 3.7% on Friday. Wages also increased faster, at a 3.1% year-on-year rate, though part of that acceleration may have been a statistical anomaly. In October last year, the US had been hit by hurricanes Nate and Philippe, which reduced the wage reading for that month in 2017, so a year-on-year comparison made the gains seem higher. Still, considering the measure had already accelerated in September, more Americans have a job and they are all making more money.

In that environment it would be unusual if stocks kept dropping. And, true to form, they did not. The S&P 500 staged a 2.59% rally last week, marked by two consecutive days of 1% or more gains, all of which saw large volumes of trading. Again, if history is any guide, November and December should be positive. In the past 40 years, 80.7% of the times the S&P gained in December, and it did so in 70% of the months of November (see chart above). That pattern is particularly consistent in years when midterm elections are held. Hopefully, it will be enough to recover from the 7.4% the stock index lost in October, marking the worst showing for the month since the Global Financial Crisis of 2008.

What, however, has also become increasingly clear is that there is only one overall direction for fixed income, at least until the end of the year: down. US Treasury yields may have stabilized, but the cost of funding continues to rise. Libor has continued its march forward and closed the week at 2.59%, the highest in a decade. The benchmark rate has risen about 90 basis points, or more than 50%, this year in an almost unchecked rise from the 1.69% it was at in the first day of the year. Hence, corporate dollar loans have become that more expensive given the vast majority of such lending is tied to Libor.

That has a particularly negative effect on emerging market corporations. On top of paying more in local currencies for US dollars, they are now seeing their interest costs go up. The rise in Libor could also prompt a rise in US defaults - which was part of the reason why the FAB AAC also decided to reduce its exposure to US corporate high-yield. Furthermore, in a rising rates environment, the only way investors in bonds can see gains in the market value of their securities is if the premium those bonds pay over US Treasuries drops. That was true for US corporate high-yield for most of the year. On 3rd October, the average additional yield that bonds in the Bloomberg Barclays US Corporate High-Yield Index pays over US Treasuries dropped to 303 basis points, the lowest in more than 10 years. The premium widened through the rest of October, but the room for further 'compression' seems limited, and perhaps not enough to compensate for potential losses caused by rising interest rates.

"The probability of losses in US high-yield bonds now outweighs the likelihood of further gains."

Similarly, the probabilities are changing for emerging markets. To be sure, the situation continues dire. The Federal Reserve has no reason to stop hiking interest rates with unemployment at a 50-year low and core inflation right at the central bank's 2% target level. The yield on the 10-year US Treasury has reflected that reality, having risen 8 basis points to 3.21% on Friday, when the October unemployment report was released. Yet, unlike the previous sudden rise in Treasury yields in early October, most emerging market currencies rose last week.

India, for instance, saw the rupee rally 1.42% amid news that the US would for the time being give the nation a waiver to buy Iranian oil and amid cheaper crude prices, which are likely to reduce the pressure on the country's trade balance. The rupee was not alone. The Turkish lira, the Argentine peso, the South African rand and even the Chinese yuan all staged strong rallies last week.

Yet, the Mexican peso dropped 3.26% last week after President-Elect Andres Manuel Lopez Obrador announced a surprise decision to cancel the construction of a new airport and potentially cause the default on billions of dollars of bonds.

The Mexican case may be a good reminder that while some of the emerging markets are staging relief rallies (most of them remain well underwater this year) the risks for the asset class remain. India, for instance, faces political uncertainty ahead of general elections in May next year. Prime Minister Narendra Modi's support has been eroded by demonetization and by rising inflation. That could undermine his position in next year's election and even if his party wins and chooses to keep him at the top post, he could be weaker. So, while emerging markets are beginning to show signs of recovery and investors may want to start considering them, it may be too early to make commit to the asset class.

The exception, at this stage, may be Brazil, where the election of right wing candidate Jair Bolsonaro to the presidency two weeks ago suggests the country may have just turned a corner. The President-Elect's cabinet so far includes the kind of people who will enact the reforms that could bring the country out of four-year economic slump. The confirmation of his election caused a bit of selling in the Brazilian currency and stock market, but that was more a factor of people closing positions established ahead of the polls. The general trend is positive and if Mr. Bolsonaro does implement the widespread privatizations, government shrinkage and business law revamp he has promised, Brazil is looking at the possibility of multiple ratings upgrades in the next few years.

"Brazil could start to reverse four years of market losses and ratings downgrades."

With that in mind, the FAB AAC decided to go overweight Latin America via a specific focus on Brazil. In other words, the FAB AAC's position remains underweight emerging markets in general, but there has been a move toward neutral in Latin America, although that was due simply to an overweight in Brazil. As for the rest of the emerging markets, the FAB AAC has taken a view to wait a bit longer before making a move into the asset class.

In that sense, members are watching two major developments which could change the tone for developing nations. The first would be what happens with Brexit. Much of the performance of the dollar this year was due to drops in the euro and the British pound, which both have suffered from the tos-and-fros of how the UK's exit from the Union at the end of March will happen. Last week saw more of that uncertainty as British authorities suggested there could be a soft Brexit agreement before the end of November, only to backtrack a few days later. There are signs that Europe is willing to compromise on some of the stickier issues, but until there is an agreement, there is the possibility that the dollar continues to strengthen, which hurts emerging markets.

The second issue is the trade war with China. There have also been headlines suggesting the world's two largest economies are coming closer to an agreement on the issue, although it may be premature to expect a resolution. The US is demanding transparency and an even playing field on intellectual property, an issue that is far more sensitive than simply the amount of imports and exports from China. Beijing is much less likely to budge on that than it could have been about trade in general. President Donald Trump and the Chairman of the Chinese Communist Party, Xi Jinping, are due to meet on the sidelines of the G-20 meeting later this month, and they could make progress toward a real agreement. However, until such an outcome is clear, **the FAB AAC is choosing to remain underweight emerging markets.**

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