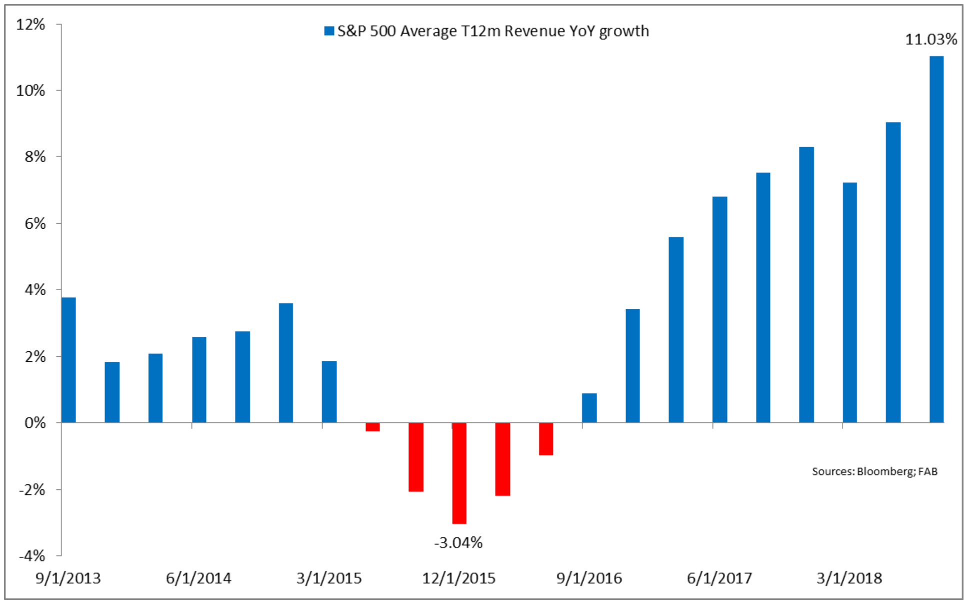
From West to East

Weekly Investment View
11th November, 2018

There are good reasons to remain bullish on US equities

Equities are poised to rally into 2019, led by the US, it seems. On Wednesday markets celebrated the end of the uncertainty about the midterm elections outcome in the US with a strong move higher. The NASDAQ 100 Index led the way, rising 3.06% that day, and the S&P 500 was not far behind, up 2.12%. The tech stock measure still needs to rally another 8.6% to recover to the level it attained on 1st October, though, while the S&P 500 is about 5.2% below its high point. To be sure, the indices gave back a bit on Friday, but they were still ahead over the week, and investors should have reason to believe both indices will reach records again. In fact, it was perhaps surprising that stocks suffered so much in October to begin with.



In nominal terms, the US economy, the world's largest, grew 5.5% between the third quarter of 2017 and the same period of 2018. Some US$1.07 trillion dollars were added to the country's gross domestic product over the last twelve months. At the same time, 2.79 million new jobs were created in the 325 million-people nation. This has helped push unemployment to the lowest rate in half a century. Hourly wages are also increasing at the fastest pace in a decade – while at the same time inflation appears quite tame.

There has been strong growth both in the top and bottom line of companies. Average 12-month revenue for S&P 500 companies grew 11% in the third quarter compared to the same period last year, the most in at least five years (see chart). This is important, because revenues are not directly affected by the corporate tax cuts enacted by President Donald Trump's administration earlier this year. Earnings have grown on average 27.4% in the third quarter compared to the same period of 2017, but that can be partly attributed to the boost from lower tax payments. Revenues, however, are a record of the extent to which people are buying products and services, and are a better measure of the health of companies listed in the US. As the numbers show (see chart above), they are doing very well indeed.

"A strong US economy normally translates into stock market gains."

How could such sound numbers and such a strong economy be accompanied by a bear market in stocks? It is unlikely, is the answer, which is why in recent months the FAB Asset Allocation Committee (AAC) remained bullish on the US stock market, despite October's performance being the worst since Lehman Brothers filed for bankruptcy in 2008. Much of the underperformance, then, may have been because of market positioning and some quirks of how stocks are traded nowadays, especially the importance of automated trading and exchange-traded funds in driving the S&P 500. Some of it was also probably a result of uncertainty related to what would happen in the midterm elections. The above veil has been removed, although the outcome was largely as the market expected. This report had indicated as far back as early August that the Democrats should be expected to take the House of Representatives, given the map of the most contested seats. The Republicans, however, retained a strong grip on the Senate, increasing their majority there.

That is key because the Senate is responsible for confirming both Supreme Court justices and Federal Reserve governors appointed by the president. Hence President Trump will continue to be able to push his nominees into the central bank and the top court, making sure that his agenda can continue to be enacted in those parts of government.

Much of what the Trump administration still wants to do can be implemented without approval by the House of Representatives, and at least one of the major issues which still requires Congress's approval, an infrastructure bill, has bipartisan support. The biggest headache the now Democrat House can give the President comes from its power to investigate the Executive branch. Donald Trump has broken protocol by not releasing his tax filings, something virtually all modern presidents of the US have done — though it is not required by law. He has also avoided questions about his potential business ties in foreign countries. All of that is likely to be on the agenda of Democrats in the House. They may also attempt to use any potential discoveries from these probes to ask for the president to be impeached. If they push through a motion to that end, however, it would require two thirds of the Republican-controlled Senate to approve it and oust the president. It is such a difficult process that even Bill Clinton's perjury in the Monica Lewinski case was not sufficient to get him impeached. The only American president in history who came close to being impeached was Republican President Richard Nixon, but he resigned before the Senate (then controlled by Democrats) voted to impeach him. He is the only American president to have ever resigned from the post.

In short, while a potential impeachment process in the House will attract a lot of headlines, it is unlikely to end with Donald Trump being removed from office. Not only because the Republican Senate holds the key to the exit door, but also because Trump continues to enjoy very strong support, particularly among poorer American voters, who have seen their lives improve during the two years in which Trump has occupied the White House. That's because job creation and wage gains have been strongly focused on low-skill labor. For instance, the average wage of an adult over 25 years old who has not finished high-school increased 7.1% in the period since Trump took office, more than the 6.1% enjoyed by college graduates, according to the Bureau of Labor Statistics. Unemployment in the construction sector, meanwhile, fell to a 20-year low of 3.4% in August, from 9.4% in January, 2017, as 445,000 jobs were created in that sector. That's in contrast with the field of securities brokerage and analysis, which saw only 35,000 new jobs created in the past 22 months.

"Donald Trump's base is benefiting from his presidency and is likely to continue to support him."

To be sure, the Federal Reserve has moved so aggressively to curb the accelerated growth pace and avoid inflation breaching its 2% target that it could slow some of the economic gains Americans are currently enjoying. The central bank has already started to acknowledge the effects of its rate-hiking in its latest meeting last week. While the Federal Open Market Committee kept rates unchanged, it said fixed investment in the economy "has moderated" instead of "grown strongly" as it had said in previous statements. That data point refers to future growth, and a drop or slowdown means next year the US will not expand at the same pace as it did this year.

This has not stopped the Fed from indicating it continues to plan another increase in rates in December, though, a fact that was reflected in the level of Libor and may have helped the sell-off in stocks on Friday. Three-month Libor rose almost three basis points on Thursday and Friday, bringing it to 2.62%, the highest level in a decade. Financial conditions, a way of measuring how hard or expensive it is to get financing, have tightened significantly. The Fed tends to pay attention to that particular metric, given that it impacts future growth as well. Finally, the dollar has continued to rise, which is keeping inflation in check, but is also contributing to the recent deterioration in the trade deficit the US experienced this year. That also is a drag on growth and something the Fed pays attention to.

"Several factors are pointing to a less hawkish Fed in 2019, though, for now, the central bank remains on course."

In reality, a good part of the reason why the US dollar continues to rise is outside the Fed's control. As Italy and Brexit continue to cast a shadow of uncertainty on the future of the European Union, global investors are favoring US assets over European ones, much in the same way the FAB AAC currently does.

The outcome of Brexit continues to be difficult to predict. The latest signs that Prime Minister Theresa May could have found an amicable solution to end the UK's membership in the European Union were shot down over the weekend. On top of that, one of her key ministers resigned as well, rekindling fears that the Prime Minister could be forced to step down and that new elections could be called, which would keep Brexit negotiations in disarray.

Meanwhile, and perhaps partly in response to Brexit, European Union authorities are playing hardball with Italy over the country's budget. The government of the nationalist coalition (including the Northern League and the Five Star Movement parties) submitted a budget that predicted the fiscal deficit rising to 2.4% of GDP next year, which Brussels rejected. The nation now has to submit a new budget this week, but local headlines indicate the nationalist parties are not stepping back much, foreshadowing a showdown between Rome and Brussels.

"Lack of clarity on what will happen with Europe and Brexit could mean more dollar strength ahead."

These two elements are likely to translate into more dollar strength, given that the British pound and the euro comprise almost 70% of the value of the dollar index. This helps explain why the index rose 0.38% last week. That, in turn, weighed on the currencies of developing nations, prompting a 0.48% fall in the MSCI Emerging Market Currencies Index.

This is likely to continue though some markets, such as India, now have favorable winds. Brent crude prices are down 10% since peaking at US$86/ barrel on 10th October, something that, alone, could help the rupee recover. As for the commodity, the downside from here is probably limited.

For inquiries related to this article, please contact:

Alain.Marckus@bankfab.com or Christofer.Langner@bankfab.com

From West to East

Weekly Investment View

11th November, 2018

Disclaimer:

This report has been prepared and issued by Products & Services - Elite & Private Banking ("P&S-EPB") of First Abu Dhabi Bank PJSC ("FAB") outlining particular services provided by P&S-EPB and does not constitute or form part of any offer or invitation to sell, or any solicitation of any offer to purchase or subscribe for, any shares in FAB or otherwise or a recommendation for a particular person to enter into any transaction or to adopt any strategy nor shall it or any part of it form the basis of or be relied on in connection with any contract therefore. This report is incomplete without reference to, and should be viewed solely in conjunction with the associated oral briefing provided by P&S-EPB. The report is proprietary to P&S-EPB and may not be disclosed to any third party or used for any other purpose without the prior written consent of P&S-EPB. The information in this report reflects prevailing conditions and our views as of this date, which are accordingly subject to change. In preparing this report, we have relied upon and assumed, without independent verification, the accuracy and completeness of all the information available from public sources or which was otherwise reviewed by us. In addition, our analysis are not and do not purport to be appraisals of the assets, stock or business of the recipient. Even when this presentation contains a kind of appraisal, it should be considered preliminary, suitable only for the purpose described herein and not be disclosed or otherwise used without the prior written consent of P&S-EPB. FAB clients may already hold positions in the assets subject to this report and may accordingly benefit from the buying or selling of such assets as referred to in this report. This document does not purport to set out any advice, recommendation or representation on the suitability of any investment, transaction or product (as referred to in this document or otherwise), for potential purchasers. Potential purchasers should determine for themselves the relevance of the information contained in this document and the decision to purchase any investment contained herein should be based on such investigation and analysis as they themselves deem necessary. Before entering into any transaction potential purchasers should ensure that they fully understand the potential risks and rewards of that transaction (including, without limitation, all financial, legal, regulatory, tax and accounting consequences of entering into the transaction and an understanding as to how the transaction will perform under changing conditions) and that they independently determine that the transaction is appropriate for them given their objectives, experience, financial and operational resources and other relevant circumstances. Potential purchasers should consider consulting with such advisers and experts as they deem necessary to assist them in making these determinations and should not rely on FAB for such purposes. FAB is acting solely in the capacity of a potential arm's-length contractual counterparty and not as a financial adviser or fiduciary in any transaction unless we have otherwise expressly agreed so to act in writing. FAB does not provide any accounting, tax, regulatory or legal advice. FAB is licensed by the Central Bank of the UAE.

London: FAB London Branch is Authorized by the Prudential Regulation Authority. Subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details about the extent of our regulation by the Prudential Regulation Authority are available from FAB London branch on request. Registered in England & Wales: Company No: FC009142: VAT No: GB245 3301 91.

Paris: FAB Paris Branch is licensed by the French Prudential Control Authority as a credit institution. FAB Paris is registered in France under the company number: RCS Paris B 314 939 547.

Switzerland: This publication is for your information only and is not intended as an offer, or a solicitation of an offer, to buy or sell any investment or other specific product. Certain services and products are subject to legal restrictions and cannot be offered worldwide on an unrestricted basis and/or may not be eligible for sale to all investors. All information and opinions expressed in this document were obtained from sources believed to be reliable and in good faith, but no representation or warranty, express or implied, is made as to its accuracy or completeness. All information and opinions as well as any prices indicated are currently as of the date of this report, and are subject to change without notice. The analysis contained herein is based on numerous assumptions. Different assumptions could result in materially different results. At any time the First Abu Dhabi Bank PJSC and/or FAB Private Bank (Suisse) SA may have a long or short position, or deal as principal or agent, in relevant securities or provide advisory or other services to the issuer of relevant securities or to a company connected with an issuer. Some investments may not be readily realizable since the market in the securities is illiquid and therefore valuing the investment and identifying the risk to which you are exposed may be difficult to quantify. Futures and options trading is considered risky. Past performance of an investment is no guarantee for its future performance. Some investments may be subject to sudden and large falls in value and on realization you may receive back less than you invested or may be required to pay more. Changes in foreign exchange rates may have an adverse effect on the price, value or income of an investment. First Abu Dhabi Bank PJSC expressly prohibits the distribution and transfer of this document to third parties for any reason. First Abu Dhabi Bank PJSC and/or FAB Private Bank (Suisse) SA will not be liable for any claims or lawsuits from any third parties arising from the use or distribution of this document. This report is for distribution only under such circumstances as may be permitted by applicable law. The "Directives on the Independence of Financial Research", issued by the Board of Directors of the Swiss Bankers Association (SBA) do not apply.

Singapore: First Abu Dhabi Bank P.J.S.C., Singapore Branch is regulated by the Monetary Authority of Singapore and holds a Wholesale Bank license.