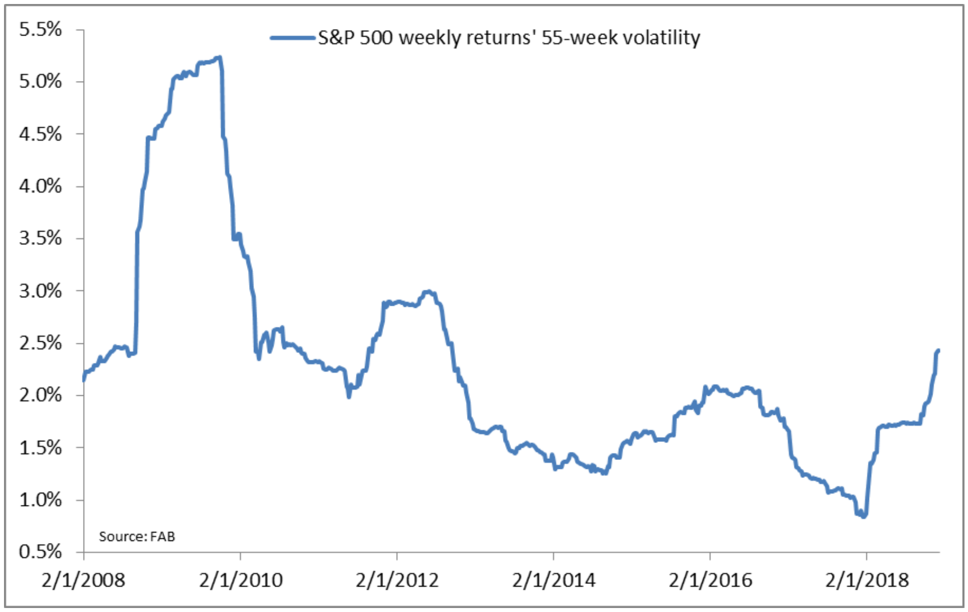
## From West to East

*Weekly Investment View*
*6th January, 2019*

# It may be volatile, but 2019 looks promising for risky assets

**January started with a boom, then a bust, then another boom. The short holiday week saw all the volatility of December summarized in almost every session. There was, however, one thing different: the S&P 500 index ended 1.9% higher, its second consecutive week of gains. The last time the index had a similar streak was in the beginning of November, and before that it had been in early September. Because of that, and due to some of the price action, January seems to have started on a more constructive tone – though, at this stage, that statement may sound optimistic.**




The very first day of trading in the US gave the tone. The S&P 500 opened down 1.2% on 2nd January, weighed by bearish positioning in the futures market following a purchasing managers survey in China that indicated manufacturing in the world's second largest economy has started to contract. Nearly 30% of the Chinese economy depends on factory output, so the news was a further indication that global economic growth is slowing. Despite the bad news, however, investor excitement about cheap stocks and a still strong economy in the US prevailed during the North-American session and the index ended higher by 0.1% on Wednesday.

Then Apple soured trading. Before the market opened on Thursday, the technology company said it was selling fewer iPhones than it expected, confirming fears which first emerged when its suppliers guided lower revenues last year. At more than 3% of the index, Apple happens to be the second largest component of the S&P 500, while internet, software and computers – the kinds of companies which drop together with Apple – comprise more than one fifth of the index. Hence, it should be no surprise that the announcement caused the gauge to drop 2.5% that day.

However, Friday brought a reminder of the issue which has dogged the market for the past three months: a complete disconnect between market activity and the economic backdrop. On Friday, the Bureau of Labor Statistics announced that the US generated a seasonally-adjusted 312,000 jobs in December, the highest number since February, 2018. The unemployment rate did tick up to 3.9%, but that was simply because the number of people considered active (or looking for a job, the so-called 'labour force participation rate') increased to one of the highest levels in five years.

This served as a reminder that the world's largest economy continues to grow at one of its fastest paces in more than a decade. The market reacted accordingly, and the S&P 500 rallied 3.4% on Friday, enough to erase the Apple-led losses and some. The excitement was also prompted by Federal Reserve Chairman Jerome Powell, who offered hints of a pause in his rate hike program in a speech on the same day, suggesting there may not be a move in March like the December one. The fact that the positive reaction far outweighed the negative push also shows that investors seem to be tired of the sell-off US stocks have endured in the fourth quarter of 2018, and which caused the S&P 500 to lose 14% in the period. If that is, indeed, the case, there could be a rally this month.

### *"There is at least one good reason to buy US stocks now: they are cheap."*

The market correction brought prices back to earth – the S&P 500 started the year trading at 14.6 times next year's expected earnings, its lowest valuation at the start of a year by this metric since 2013 (the year of the 'Taper Tantrum', and also one in which the S&P 500 rose 29.6%, its best showing since 1997).

The dividend yield touched 2.3% in mid-December too, 45 basis points higher than the 1.85% average of the past 20 years (which includes the 2008 financial crisis period, during which returns breached 4% by this metric), and remains at 2.1%.

That alone would be a good reason to invest. Even assuming the unlikely event that a major financial crisis unfolds this year – as markets seem to have implied in December –, investors who buy the S&P 500 at these levels are getting great long-term returns. The index has increased at a compound annual growth rate of 6.8% in the past 50 years, which added to the current dividend yield offers a very handsome return.

To be sure, it was not all smooth-sailing in the past half century. If someone bought the S&P 500 on 31st December 1999 and sold on the same date in 2002, the investor would have lost 40%. A similar trade between the last days of 2007 and 2008 would have logged losses of 38.5%. But negative years are the exception, not the norm. Only 13 of the past 50 years were negative for the S&P 500, and only twice were there two consecutive negative years, both following serious economic shocks. Meanwhile, yearly gains after bad years – such as 2018, in which the index fell 6.2% – were more commonly followed by very strong returns. In 2003, the S&P 500 rallied 26.4%, and in 2009 it gained 23.5%, for instance. There is no guarantee that this year will be like that, but there are a lot of rational reasons for that to be the case.

**A similar storyline and equivalent arguments could be made about crude oil prices.** Brent crude rallied on the first day of trading, dropped together with Apple shares, then rallied again. While some of the movement could be attributed to economic expectations being reflected in the price of the commodity, the erratic behavior could also be partly due to a changing oil trading landscape. Last year, oil traders, which have traditionally been big players in crude futures, lost lots of money because of wild swings in the market, unexpected oddities (such as unusual premiums for certain grades of oil), and higher cost of funding. Some went out of business altogether, leaving the field increasingly dominated by speculators. That has, at times, disconnected the reality from market prices.

Now, there is a good reason for oil prices not to be as high as they were in September: demand from emerging markets has fallen. But OPEC, other producers that align with the group and Canada have started to cut production by a combined 1.5 million barrels/day. Shale oil production in the US has also shown signs of plateauing at the record 4 million barrels/day it reached in December. Permian production tends to drop some four to five months after crude prices fall significantly as they just did, and that should start becoming apparent in February.

Meanwhile, as oil prices dropped and emerging market currencies rallied in the fourth quarter, fuel has become more affordable in the poorer countries again. That should staunch the demand loss and perhaps even bring back some of the consumption growth these countries were spurring until last year.

***"Oil is moving to a supply shortfall environment, but it may not be apparent yet."***

**Crude prices, however, tend to react to supply and demand imbalances when these start to show in inventories.** The recent correction, in fact, started after inventories showed a build-up in late September and early October. Before that, the rally had started after large stockpile drawdowns. Assuming demand is starting to outpace supply, refiners are likely to start tapping oil in storage soon. In fact, they already have. Since the end of November, the US Department of Energy's weekly monitor has shown negative changes in inventories, with the exception of the last week of December, when stores rose a mere 7,000 barrels.

Higher oil prices would be particularly bullish for Middle-Eastern stocks. Some of the regional markets had already had a banner year in 2018 by many measures. Saudi Arabia and Abu Dhabi were respectively the best and second-best performing stock markets in the world last year in local currency terms. Curiously, however, Dubai was the worst among major markets. While Abu Dhabi and Dubai are very different markets, the more dovish Fed and the outperformance of the neighboring equity index should provide a boost to the latter. Falling property prices were an important part of the reason why Dubai performed so poorly last year. With interest rates stabilizing and the looming Expo 2020, investors are likely to turn back to housing in the Emirate, and that could help its stock market recover.

***"Dubai was the worst market in 2018 while Abu Dhabi was the second best. Those markets could converge and rise together in 2019."***

**Had it not been for the last quarter, 2018 would have been a great year. It turned out to be very difficult, and one in which cash outperformed all major asset classes. Yet, the FAB Asset Allocation Committee (AAC) managed to outperform the market, with its suggested balanced portfolio losing far less than most other asset classes.** The AAC remained 'risk-on' even during the fourth quarter and did not remove its 'overweight' stance in US equities, confident that the correction was temporary and would not exceed 10% by much, which suggested the downside of reducing exposure for a short period of time outweighed the upside. The jury is still out on that decision, but other moves such as hedging part of the European exposure, keeping high cash, betting on Brazil in October — when the Committee also reduced the overweight position in US corporate high-yield — proved prescient and lucrative for clients.

The AAC starts the year aware of the heightened volatility but with a general sense that there is reason to be bullish. The Committee remains overweight US equities and has, in fact, increased that position in November. In its last meeting of the year the group also decided to overweight emerging market dollar-denominated bonds, particularly sovereign debt, given that yield premiums look very attractive and several factors point at 2019 being a good year for EM assets. In its first meeting of 2019, expected to be held this week, the AAC is likely to discuss whether to increase the allocation to EM equities as well.

**The most important lesson of 2018, however, was that diversification is a powerful tool.** Even when correlation was high, with several assets falling together, investors who chose to carefully diversify their portfolios suffered less. There may be times when diversified portfolios earn less too, but as Aesop put it 2,700 years ago, steady wins the race.

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