From West to East

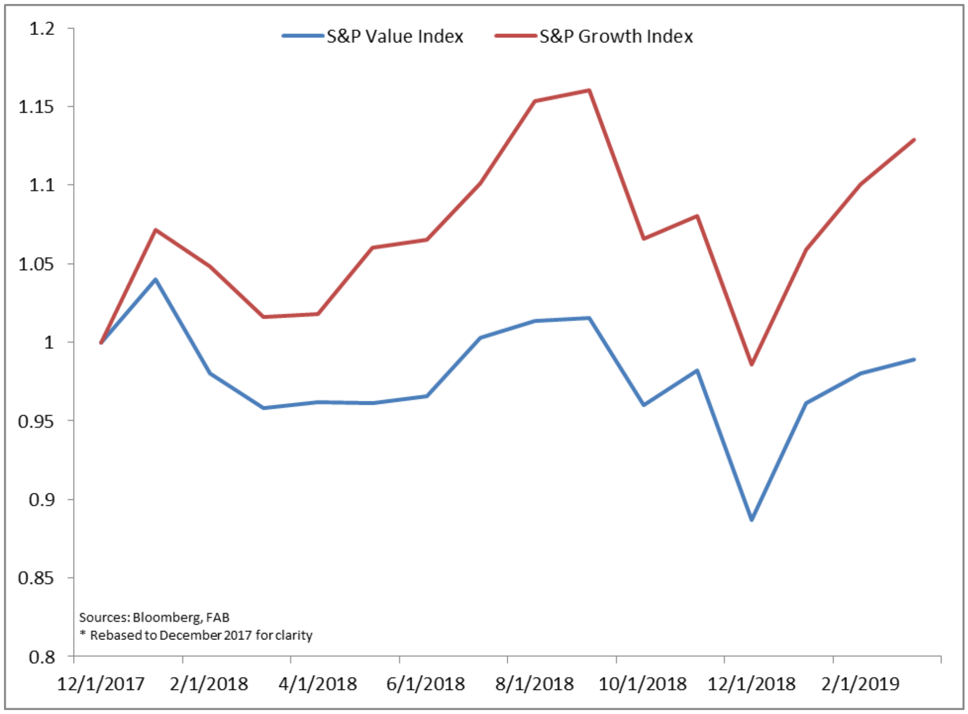
Weekly Investment View

7th April, 2019

Goldilocks US economy could fuel new stock market records

If there was ever a US jobs report tailor-made to fuel a rally, last Friday's was it. The 196,000 jobs created beat analyst estimates, the numbers for the previous two months were revised higher, yet wage growth slowed down. The first part of the data dispels fears of an impending recession in the US, and the second suggests inflation is still far enough away that the Federal Reserve should remain dovish. In short, there was enough in it to make investors happy, and for the Fed not to be worried about its dovish stance.

The so-called 'Goldilocks' economy (not too hot, not too cold) could not be better reflected in a single report. The result in the US stock market was immediate, with the S&P 500 ending Friday up by 0.46% and, perhaps more importantly, confirming that it has broken through a sticky resistance level at around 2,830. At its Friday closing of 2,892.74, the index is now just 1.1% below its all-time closing high of 1st October last year, meaning that record could be tested as early as this week.



"Usually, new stock market highs lead to further highs."

And given the economic and rates backdrop, it is unlikely that investors will use new highs to take profits.

Where the market will advance to from here is unclear, however. The key risks that dogged investors last year appear mostly priced in. The trade dispute with China, for one, has already taken its toll on the markets. It is, anyway, close to resolution. Last week, Liu He, the Vice-Premier of China, said a new consensus had been reached in the negotiations. President Donald Trump also praised the progress made after meeting Mr. Liu personally, although he said he did not want to predict the outcome. All this comes as news reports suggested that Communist Party Secretary General, Xi Jinping, wants a deal soon.

While the risk remains that an upset regarding the trade deal sends markets reeling, it is unlikely that would cause as much pain to US stocks as it did in the fourth quarter of last year. In fact, in many ways, the trade dispute was only partly responsible for that sell-off. In hindsight, investors seemed to be selling stocks based on fears that US economic growth would quickly fizzle out because the Fed was increasing rates too fast. Amid that backdrop, having a trade war would have really made a dent.

Evidence of that can be seen in the fact that markets only began to retreat in October, although the trade war began in earnest in April, when the US first established it would apply tariffs on Chinese products starting from June. That retreat followed a more hawkish-than-expected Fed statement on 26th September, which prompted the yield on 10-year US Treasuries to spike 15 basis points in the first week of October.

That sudden move may have been more to blame than all the months of back-and-forth between the US and China. It has also been reversed, with the more dovish turn taken by the Fed in the past three months.

Hedging activity from mortgage investors could help explain these sudden moves too. The US has US$15.4 trillion of mortgages outstanding, according to Fed data. At least a third of that is held by investors, who tend to hedge their expectations of repayment activity using 10-year Treasury futures (the average life of mortgages in the US is 10 years). Higher rates mean fewer people refinance their mortgages, and the duration of home loan portfolios becomes longer. To compensate for that, mortgage investors short 10-year Treasuries. The reverse is also true. When the Fed became suddenly dovish in January, and even more dovish than expected in March, 10-year US Treasuries rallied strongly as, perhaps, some of the shorts established by mortgage investors were covered. That

dynamic is also likely to be absent in the coming months, removing another source of angst for stock and bond investors.
The turn in rates expectations has also brought leveraged investments back into play, as three-months Libor retreated 21 basis points in the first quarter. This favours momentum and growth stocks as investors are encouraged to use more margin, and because the present value of future growth increases.

"Technology stocks could benefit most from the rebirth of momentum strategies."

That is true even as the technology sector has already staged an enviable rally despite a measured reduction in earnings expectations. For instance the Philadelphia Stock Exchange Semiconductor (SOX) Index, a bellwether for computer hardware companies, posted a new record when it closed at 1,477.65 on Friday, making it the first sub-sector to have erased the losses of the fourth quarter. It is up 38.18% since its recent low of 24th December. The Nasdaq 100 is yet to reclaim the recent highs of October, but it was up 15 of the past 20 trading days. Meanwhile, earnings growth expectations have been trimmed for the sector. The median estimate for year-end earnings per share for the SOX index has dropped 7.2% since the beginning of the year, and by 4% for the Nasdaq 100. That said, over the past decade technology stocks have consistently delivered earnings growth, and investors are willing to pay more for growth amid these low rates.
In fact, the value ascribed to any investment that offers higher returns has just gone up even more after the jobs report. That means that high-yield bonds are also poised to rally further, particularly since they have a high correlation to stocks. Investment-grade securities that offer higher returns may also outperform. That includes bonds with longer maturities and any debt that offers better yields relative to similar bonds. Debt from countries in the Gulf Cooperation Council fit that bill as they still offer on average 50 to 75 basis points more in yield than equally-rated securities with the same maturity. And while investors expect a significant amount of new issuance in the GCC this year, particularly from Saudi Arabia, that may increase to the appeal of bonds in the region.
The upcoming giant bond transaction of Saudi Aramco — which the Sunday Telegraph said would top US$ 15 billion — is a case in point. While such a large transaction could impact spreads for GCC bonds in the near-term, it is actually likely to ultimately tighten them. Unlike the stock market, when it comes to bonds, more issuance can ultimately reduce premiums. China is a perfect example of this. In 2013, the first year that Chinese corporate bond issuance offshore breached US$50 billion, the average spread on Bank of America Merrill Lynch's China Investment Grade index was 198 basis points. The index continued to rally even as issuance skyrocketed, and by the end of 2017 (a year when Chinese corporations sold more than US$ 450 billion in bonds, according to Bloomberg) the average spread was 124 basis points. In fixed income speak, this is called a 'liquidity premium', which means that having fewer bonds outstanding entails more risks for investors.

"GCC bond investors pay a liquidity premium that more issuance from the region could reduce."

Aside from the potential reduction in the liquidity premium and their still relatively high spread over US Treasuries, GCC bonds should enjoy recently being included in some of the largest EM bond indices, something that is only beginning to be implemented.
Similarly, index inclusion should continue to boost Saudi stocks. Expected foreign inflows from the country's addition to major global EM indices such as the MSCI and the FTSE have probably not been fully priced-in, and the average multiple for that market seems likely to increase further, suggesting it may still have worthwhile upside potential. Saudi stocks could also see a pop this quarter due to technical factors. The FTSE inclusion began to be implemented officially in March, and the official shift in the MSCI index happens in May, which is when the Holy Month of Ramadan happens this year. That is a time when most Middle Eastern investors are not focused on trading. Hence any increase in demand for stocks in May could prompt stronger price moves than normal.
Furthermore, while most investors tend to 'front-run' index inclusion implementation, many international institutions stayed away from the Saudi market last year because of political issues. That means flows expected in 2018 were delayed to this year, suggesting there is room for a further rally in the Tadawul Index.
Naturally the main risk to the index (and those of its neighbours) is any sudden drop in oil prices. The opposite seems more likely right now, as Libyan National Army leader, Khalifa Haftar, is launching an assault on Tripoli in an attempt to take over the nation's capital. This surprise move accelerated over the weekend, and seems likely to positively impact crude oil prices in Monday's trading. To be sure, Brent crude prices have been having trouble breaching the US$70/barrel level, suggesting that in normal times this may have been a resistance point.

"In the near term, lack of excess supply and geopolitical turmoil could boost crude prices further."

That is bad news for India, which tends to see pressure on the rupee when crude prices spike. The news from the country, however, is mostly supportive of its assets. The latest polls have shown that Prime Minister Narendra Modi's popularity has recovered after what was viewed as a strong reaction in a dispute with Pakistan in March, leading a majority of investors to bet he will be able to remain in power.
Inflation has also been in check, which allowed the Reserve Bank of India to make its second rate cut this year, bringing the benchmark rate down to 6%, one of the lowest levels since 2010. Economists expect at least one more cut this year, which could drive higher valuations in India, too.

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Weekly Themes

Technology sector	⇧	A Goldilocks economy favors growth and momentum stocks. Beware of media companies, however.

AAC Strategic Position

ASSET CLASS		WEIGHT	
Fixed Income		**Slightly Underweight**	
	Corporate bonds		Underweight
Equities		**Overweight**	
	Asia ex-Japan		Overweight
	Latin America		Overweight
Alternatives		**Underweight**	
	Hedge funds		Underweight

* Arrows in the 'Weekly Themes' are for illustrative purposes only and do not imply investment advice or forecasts of performance for selected asset classes. Conclusions in specific boxes are derived from facts as of publication and may change quickly. The AAC grid shows only non-neutral positions, for more details please refer to the asset allocation grid.

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