From West to East

Weekly Investment View
10th March, 2019

The world slows down and risk appetite slackens

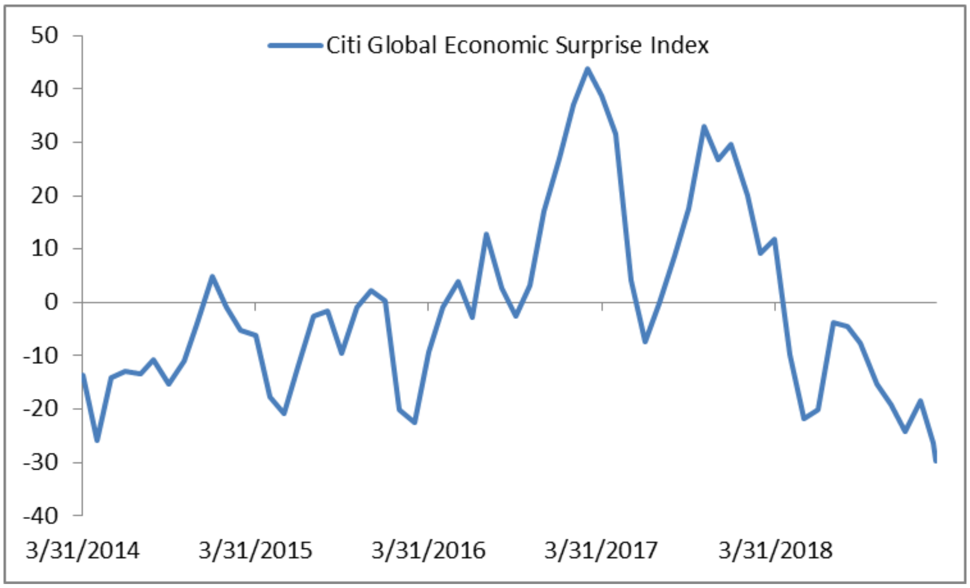
If there was ever any doubt that the US economy is slowing, last week's employment report provided proof. The country generated 20,000 jobs in February, instead of the 180,000 the median projection of economists surveyed by Bloomberg suggested. That was the lowest figure since September, 2017. Confronted with the miss, President Donald Trump's economic adviser Larry Kudlow said the report was "very fluky".

Perhaps, but an economic slowdown is apparent across the globe. Last week, the European Central Bank revised its 2019 growth forecast for the EU to 1.1% from the 1.8% it expected in December. The Bank of Japan reduced its inflation projections a few weeks ago, and Chinese lawmakers endorsed a lower growth target of 6%-6.5% during their annual meeting last week.

However at least the round of economic reality checks was met by liquidity pledges from the various central banks. Federal Reserve Chairman, Jerome Powell, reiterated he is in no hurry to raise rates in a speech late last Friday night. ECB Governor, Mario Draghi, said Eurozone rates will not be raised this year and announced a new round of cheap bank funding last week. At the same time, China cut taxes for small and medium-sized enterprises, and relaxed constraints on debt issuance.

Still, stocks reacted negatively. The S&P 500 had its worst week of the year, down 2.16%. The Euro STOXX 600 index fell 0.98%, and Japan's Nikkei 225 index dropped 2.67%. Meanwhile, the US dollar index rose 0.81%, although the Swiss franc and Japanese yen rallied 0.89% and 0.65% respectively.

The moves are in line with the expectations of the FAB Asset Allocation Committee (AAC), which decided to reduce its exposure to risky assets on the last day of February by reducing its position in US equities to neutral from overweight. The resulted partly from the strength and speed of the rally the asset class staged in the first quarter, and the fact that the S&P 500 Index was approaching a technical cap, the 2,800 level, which it had not consistently breached since early October.



Yet, the AAC still expects the US stock measure to end the year with strong returns. However, the Committee agreed fundamental concerns could undermine the rally in the coming months.

"The factors that prompted our AAC to tactically reduce its commitment to US stocks remain in place."

Because of that and in addition to the losses the S&P 500 logged last week, the sell-off seems likely to continue for the time being. In fact, the bad week may only exacerbate the dynamic. Active fund managers, who may have seen the 2,800 level as a signal to sell stocks and lock in gains ahead of the end of the quarter, will likely feel vindicated and to continue taking risk off the table until the end of March. We believe that even a trade agreement between the US and China is unlikely to trigger a rally.

News reports last week suggested President Donald Trump had been pressing his trade team to achieve just that: a deal that prompted an equity rally. However, that outcome is probably already priced into US equities. The trade deal is elusive in any case. While the President himself is seeking a victory on the international front, even if not a resounding one, his trade team led by Trade Representative, Robert Lighthizer, is pushing for a more comprehensive agreement that addresses bigger issues, such as intellectual property and forced technology transfers.

Mr. Lighthizer was reportedly also pushing for mechanisms to enforce the agreement, a move that prompted Chinese Vice Commerce Minister, Wang Shouwen, to call for ways to ensure the US is also keeping its own end of the bargain. Even if a deal is signed it is unlikely to be that easy, and probably will not be the world-changing agreement that some may have expected. It could all turn into an anti-climax instead. That, again, could be detrimental to sentiment when investors are already prone to reducing their risky bets, still scarred by the sell-off they suffered in the fourth quarter.

As for China, while it may superficially play tough on trade, it is hardly in a position of strength. The country has already seen the impact US tariffs can have on its economy and would probably want to avoid further duties – witness last week's poor Chinese export statistics.

The country, however, has been trying to counteract the impact of these tariffs by releveraging its economy. As a result, total credit in the economy grew about 25% faster in the first two months of this year compared to the same period of 2018. With the credit spigots open, the country could recover faster than expected once the uncertainty related to the trade agreement with the US is removed.

Stock markets had started to price-in that possibility, and for most of the past two weeks Chinese equities were up even as the S&P 500 dropped. That reversed on Friday, however, when the CSI 300 index fell 4.07% after a local brokerage issued a 'sell' rating on a security that led the rally last week. In any case it was thought that Beijing wanted the rally to slow down after the CSI 300 had gained 26.5% in US dollar terms between 1st January and 1st March.

The recent up-move in Chinese equities was fueled by a return of international investors, attracted by relatively cheap valuations, which, by the way, remain attractive. Even after the strong showing so far this year, the CSI 300 index is trading at just 10.25x expected 2019 earnings, below levels of three years ago and less than the 12.7x average ratio of the past five years. So despite the hiccup, there is room for more gains into year-end. The AAC is retaining its positive medium-to-long term view on Chinese equities.

The drivers for the Chinese equity rally remain little changed. This year, Chinese authorities began to remove several of the restrictions previously imposed on stock trading, bringing retail investors back into the market. As long as those constraints do not return, the rally is likely to carry continue, though last week's move could slow its momentum for a while.

"Chinese stocks have risen so fast the government may want to curb the rally."

Another market which currently has strong underlying push factors in the coming months is Saudi Arabia. The Tadawul Index wobbled last week after reports that the tax authority was mulling doubling the Zakat levy (tax) for local banks, which comprise a significant part of the stock index. The tax authority, however, issued a statement on Friday denying that rumour and prompting a recovery on Sunday.

Similarly to China, Saudi stocks have plenty of underlying support. After a sell-off in the fourth quarter, valuations are not excessively high and a recent upgrade to emerging market status by index providers MSCI and FTSE are likely to result in additional inflows. Those inflows could also come at a time of low liquidity.

While much of the investment expected from the upgrades may have already been made, 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. A sudden rise in demand in May could prompt stronger price moves than normal.

"The Saudi market still has a tailwind behind it."

Finally, oil prices have been resilient. The commodity has rallied more than 30% since 24th December, when Brent crude prices hit their recent bottom of US$50.47/barrel. Brent rallied 1% last week.

To be sure, however, risks are relatively balanced for oil prices at current levels. While OPEC and some of its allies have kept to their promise of cutting supply, the current global economic slowdown is likely to translate into slower demand growth. Meanwhile, shale oil producers in the US are logging record output and new transportation infrastructure could soon make exports of that crude easier, reducing the premium Brent currently commands over West Texas Intermediate oil. Those factors suggest a strong rally from current prices is unlikely for now.

Besides putting a cap on the oil price rally, slower economic growth across the globe could reignite the wave of populism across the globe. That dynamic may become evident in Italy, which economists believe entered a recession in the first quarter, after logging no growth in the last three months of 2018. Even positive manufacturing numbers last week may not be able to stop the downward momentum.

The Italian slowdown was partly fueled by political uncertainty in the country, which is only likely to increase in coming months. Negative economic numbers are likely to fuel further populism and more clashes with the EU over budgetary constraints. They are also likely to deepen a rift in the ruling coalition. Last week, the two Deputy Prime Ministers fought publicly over a rail link with France, which Matteo Salvini supported, and which Luigi Di Maio wanted to block on environmental concerns. Both are the leaders of the key parties in the coalition and, if their disagreement gets out of hand, President Sergio Mattarella could call elections, prompting even stronger rhetoric — and investor uneasiness.

"Political uncertainty in Italy and the UK suggest caution about EU assets."

If the prospect of Italian turmoil were not enough to completely deflate excitement about European assets, Brexit seems likely to do so. This week, the UK Parliament is expected to vote again on an agreement Prime Minister Theresa May had reached with Brussels last year. She had been expected to tweak issues related to the so-called Irish 'backstop' but her negotiations were unsuccessful, and reports on Sunday suggested she may suffer an even bigger defeat than the one she endured the last time her deal went up for a vote.

If the deal fails to pass, ministers are expected to vote the next day on a bill to remove the possibility of a no-deal Brexit and thus potentially delay the UK's departure from the EU. However, a Sunday Times report suggested that a resounding defeat could prompt Mrs. May to cancel that second vote, raising the specter of a hard Brexit by 29th March. In simple terms, the worst may be yet to come in Europe.

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