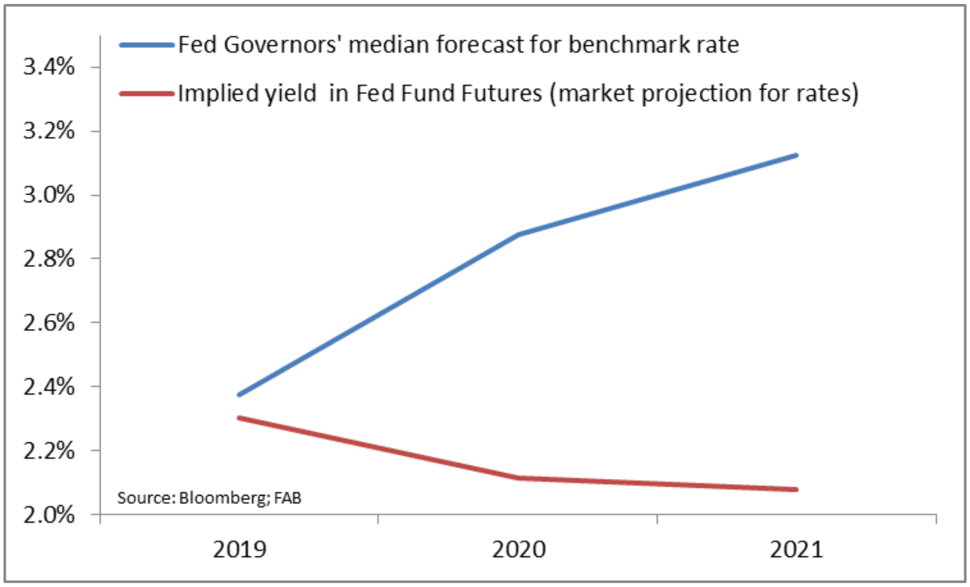
In euphoric markets, focus on expected returns avoids pitfalls

Seldom can an investor time the market perfectly. Instead, they often work with expected returns and try to enter securities and markets when potential gains are higher than probable losses. That was one of the factors the FAB Asset Allocation Committee (AAC) considered when it decided to reduce its exposure to US stocks to neutral from overweight earlier this year. Then, the S&P 500 had just hit a technical resistance at 2,800 points, one that it had struggled to overcome several times in the past six months. The short-term potential gains from there, if the index held above that level for long enough, were around 5%, considering recent highs. Meanwhile, the potential losses if the index repeated last year's pattern were closer to 15%.



The index lost a bit in the following days but last week it recouped all of those earlier losses and it is now holding above the 2,800 resistance. If it does so for a few more days, investors may become convinced of the rally and pile back into US stocks. Given that it is the end of the quarter, that movement could cause a sharp movement up. At this time, money managers usually square their books as they prepare to report to clients. That means taking profits if they expect markets to turn around, or putting cash to work if they were being overly cautious but do not want to send that message to investors. Hence, securities that did well throughout the quarter often stage a last minute rally toward the end of the period and vice-versa.

In fact, market performance in the next two to three weeks is binary, with the potential for significant rallies or losses. The move in either direction will hinge on so-called 'triggers'. The key one will be the Federal Reserve.

The US central bank meets this week to decide whether to keep rates on hold or to move them higher. There is a broad consensus that the bank will leave the benchmark interest rates unchanged. The more important information will come from the board of governors' summary economic projections. Every three months, the Fed governors unveil their forecasts for unemployment, growth and interest rates. That has served as a roadmap of future interest rate decisions for investors. Part of the reason why there was such a strong sell-off in the fourth quarter last year was because of these projections. Then, economists predicted that the Fed would topple the US into an early recession if it followed its projected path, which then caused investors to exit risky assets.

In December, those projections (see chart above) predicted two interest rate hikes this year. Meanwhile, the implied yield on fed fund futures (the interest rate that the Fed controls), suggests that by January 2020 the central bank will have cut rates instead. That means that either the Fed will change its forward expectations to reflect that interest rates are not moving (or even being cut), or the market will have to reevaluate what it expects the Fed to do in the next year.

"Bond markets could correct if the Fed continues to signal more rate hikes."

From the economic standpoint, there are arguments for the Fed to raise rates at least once more. Part of the reason why the central bank's communication turned dovish in January was because the correction in the fourth quarter tightened financial conditions. That measure looks at how easy it is for companies to raise money and is the market component in the Fed's model. The market trouble has been removed with the rally in the first quarter. Meanwhile, inflationary pressures remain. Unemployment is near the lowest in half a century while wages increased 3.4% year-on-year in February, the fastest pace in a decade. Rising wages usually lead to higher inflation, so the Fed is likely to see the potential for consumer prices to rise faster and may want to curb them. That could translate into a 'dot plot' showing at least one more rate hike this year.

The flip-side of the argument is in the weakness of some of the recent data. The most notable one was that the US created only 20,000 new jobs in February, far less than the 180,000 median estimate of economists surveyed by Bloomberg. That number, however, has been seen as a statistical anomaly and is unlikely to sway the Fed away from its inflation concerns.

However, the Fed is on pause at least

until September. That is partly due to the uncertainty around the direction of the world economy. While the US continues to grow at a healthy pace, there are lots of evidence about a slowdown elsewhere. Chinese exports and economic growth surprised to the downside, prompting the government to announce additional stimulus measures over the weekend. Premier Li Keqiang announced a further cut to value added taxes, after having announced a slash earlier this year, while indicating that the People's Bank of China may cut its benchmark interest rates again, after several cuts in the past year.
The outlook for Chinese growth, however, may be underestimated. The country has loosened leverage regulation and lending grew at the fastest pace on record in January. The short-term performance of Chinese stocks and even the economy, however, may still hinge on the country reaching a trade agreement with the US. That subject saw conflicting messages last week with some US authorities indicating that an expected meeting between President Donald Trump and Xi Jinping, the Chairman of the Chinese Communist Party, would not happen before April. Chinese authorities later balanced that, saying that the negotiations had achieved major progress.

"Both China and the US want to achieve a trade agreement in the near future."

For now, though, the uncertainty about the outcome of the trade dispute could weigh on the Fed's growth forecast. The central bank is also likely to hedge against the potential volatility that could stem from a hard Brexit. That prospect seems to have been delayed, but not eliminated, after the UK Parliament chose to extend the country's exit from the EU last week to negotiate some of the issues keeping some members of Parliament from voting in favour of Prime Minister Theresa May's deal, which has suffered a second defeat. However, the extension is about to open a Pandora's box. Any delay of more than three months means that the UK would have to elect representatives for the European Parliament. Such polls could stoke anger among the majority who voted for the nation's exit from Europe, and lead to new elections. A delay of only three months is also unlikely to provide enough time to tweak the current agreement to the liking of Parliament.

There are a few possible timeframe scenarios. If the EU wants to allow only cosmetic changes to the current deal, the extension will not be beyond 18th May, the day when the EU Parliament will be dissolved for the bloc's elections and one of the last chances for it to vote on Mrs. May's deal – which the EU Council ratified on 11th January.
The extension could be until after 1st July, when the new members of the European Parliament take their seats, but no later unless the UK elects its own representatives. In effect, this extension is likely to be much longer and lead to new elections in the UK. As it stands, therefore, the probability of a hard Brexit remains pretty much 50%. Even that assumption may be sanguine, given that 278 MPs voted in favor of a hard Brexit on 13th March, a sign that the support for a no-deal exit is perhaps stronger than headlines may suggest. The alternative of a soft Brexit would probably only be achieved after lengthy new negotiations with a newly seated European Parliament.

"Given the deadlock in the UK Parliament, it is unlikely a final Brexit agreement would be quickly achieved."

Finally, there is the possibility of a second referendum, which would also probably trigger new elections in the UK. It is unclear, however, whether Bremain would win this time and if the divorce option wins again, a hard Brexit becomes more likely. That additional source of uncertainty is likely to weigh into the Fed's expected decision of signaling patience yet again, even if the central bank, as stated before, could continue to signal at least one more rate hike ahead. Again, that could mean a market adjustment and the US dollar is likely to react the quickest. The currency has strengthened marginally this year even as investors began to assume the Fed would be on pause for now, but any indication of further rate hikes could accelerate that move.
That is bad news for emerging market currencies, though it may not affect all of them equally. The Indian rupee, for instance, has appreciated nearly 4% since the start of February. That path may be further supported after the Reserve Bank of India revived foreign exchange swaps to control dollar liquidity last week. The uncertainty of the election outcome, however, continues to loom over Indian assets.

"The rupee's rise skews the currency's expected return downwards."

The Fed will not be the only key meeting this week. Middle-Eastern investors will be watching an OPEC gathering which is likely to show that the group has been successful at curbing output. That expectation together with a surprise drop in US crude inventories last week helped spur a 2.16% rally in Brent crude prices last week. At these levels, however, once more, the risk to the downside seems more significant than the potential gains. **With the global economy slowing and shale oil output in the US hitting a record 3 million barrels/day last month, the downside risk for oil prices is rising.**
Even if oil corrects in the near future, Saudi Arabian stocks may find support as 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. The FTSE inclusion began to be implemented officially two weeks ago and the official shift in the MSCI index happens in May, which coincides with the Holy Month of Ramadan this year, 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.

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From West to East

Weekly Investment View
17th March, 2019

Weekly Themes

Asian High-Yield	⇧	China announced additional fiscal and monetary stimulus, which favours leveraged borrowers.
Asian Equities	⇧	Lower rates and taxes could boost earnings just as key indices increase their Chinese allocation.
Energy Sector	⇩	Valuations have become stretched and the upside for oil has become more limited.

AAC Strategic Position

ASSET CLASS	WEIGHT
Fixed Income	**Slightly Underweight**
Corporate bonds	Underweight
Equities	**Overweight**
Europe	Slightly Overweight
Japan	Slightly 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.

From West to East

Weekly Investment View

17th March, 2019

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