Investment Weekly

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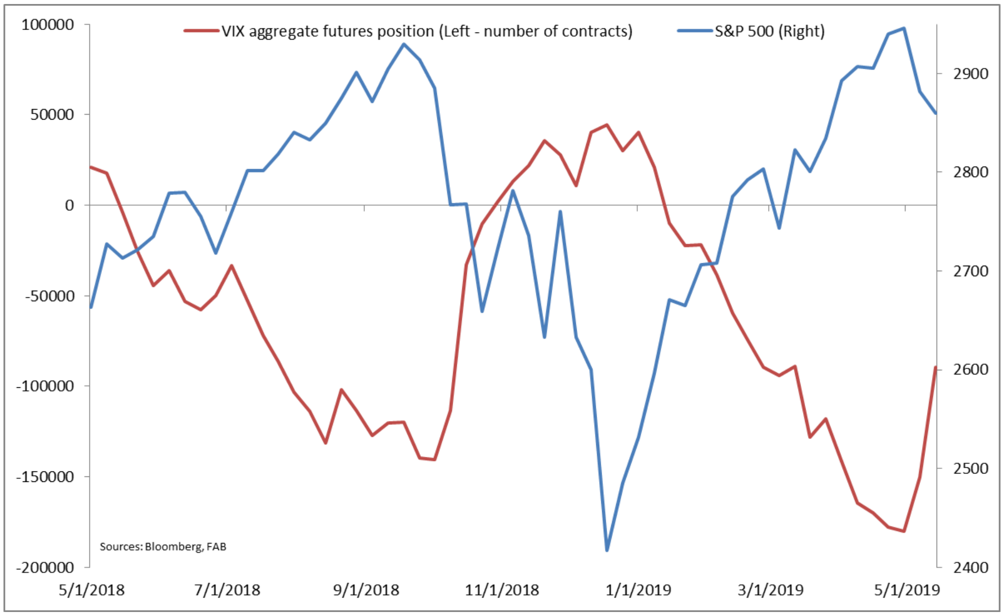
US sell-off loses steam and signals a reentry point

After posting one of its worst one-day losses of the year on Monday, the S&P 500 gained for three consecutive days. It still ended the week slightly negative due to some selling on Friday. Short-volatility positions have nearly been cleared, and the way may soon be open for US stocks and US high-yield to begin to recover.



While the trade war has continued to escalate, the potentially disparate impact of it on China and the US has started to become evident in the performance of both the currencies and the stock markets of both countries.

The MSCI Emerging Markets Index is down 7.98% since 3rd May, reflecting a 7.1% drop in the Hang Seng Index among others. About US$2.8 billion left Chinese markets last week alone, the biggest outflow since 2015, according to the International Institute of Finance. Altogether, US$13.65 billion was pulled from emerging markets in the past two weeks.

Meanwhile, the S&P 500 is down 2.92%, and there are technical signals indicating it could soon start to hike its way back to the records it set in April. One of them is shown in the chart above. **Just before President Donald Trump's 5th May tweet that reignited the trade war, investors were so confident that the stock market would continue to rally that there was a record amount of contracts betting the VIX volatility index would drop.**

Such bets were upended as the VIX rallied after President Trump's move, and had to be reversed. Weekly data shown in the chart's red line indicates that on aggregate speculators went from being short the VIX by a record 180,359 contracts on 30th April to only 89,696 last Wednesday. That shift alone causes some selling in the S&P 500, whose implied volatility the VIX measures.
As the numbers suggest, there still could be some selling, but the worst has probably passed. Meanwhile, the key drivers for US stock market outperformance remain untouched. Inflation numbers have been tame, and last week had more examples of that as import price indexes came in below expectations, despite tariffs on Chinese goods. Housing starts and building permits also surprised positively, which helped some metals rally amid prospects of a recovery of the US property market. Finally, jobless claims, which help investors assess the unemployment trend, fell to 212,000 last week, near the 50-year low touched on 30th April. In short, **a US recession continues to be unlikely for now**.

In a meeting on Thursday, The FAB Asset Allocation Committee (AAC) recognized that the US economic situation warrants remaining 'risk on'. Members, however, did not vote to return to an overweight in US equities yet, as they wanted to wait for certainty that the selling pressure has subsided. The AAC, however, felt that some of the drivers for an underweight in corporate bonds were no longer in place and decided to move that position to neutral.
That position had been put in place when the Federal Reserve was showing an increasingly hawkish bias, suggesting that defaults could rise and that bond prices could drop further. Now, however, the consensus among AAC members is that the Fed will not increase interest rates at least for the next nine months, if not longer.
The increased exposure to corporate bonds would be done gradually, the AAC members decided, and would be expressed primarily through US high-yield corporate bonds (see page 3). That allows investors to capture some of the potential upside of US equities, while reducing the volatility of that exposure — junk bonds are highly correlated to stocks, but are much less volatile. The main caveat to the shift to neutral is timing, given that a rally in US Treasuries in the past two weeks, suggests the best entry point for the asset class may be in coming weeks.

Bets on lower volatility that helped spur a US stock sell-off have nearly been reversed

Meanwhile, the AAC decided to take profits on an insightful investment into Chinese equities, which helped the balanced portfolio outperform so far this year. The CSI 300 index of stocks traded in Shenzhen and Shanghai was up 34.27% in dollar terms between the first day of trading in 2019 and 30th April. Such returns would already be cause for caution about the overweight position in Chinese equities that the AAC held until last week. However, the escalation of the trade war and the impact it has on the value of the Chinese yuan suggest the downside potential could be significant.

The Chinese currency has a very clear impact on stocks, as the chart below shows. It has already dropped 2.64% against the US dollar since President Trump said he would increase tariffs on US$200 billion of Chinese imports to 25% from 10%. That move is also likely to spill over into other currencies. The Indian rupee, for instance, has dropped 1.47% over the past two weeks and the broader MSCI Emerging Market Currencies index is down 1.6% in the same period. On the flip side, the US dollar index is up 0.49%.

The AAC, however, remains bullish about the growth prospects for EM, and may reinstate an overweight on it once the trade war simmers down. In the meantime, careful stock-picking in EM can still yield outsized returns, particularly after a sell-off. Finally, Chinese stocks show a lower correlation with US stocks, so are worth holding in a diversified portfolio.

Elsewhere, **Gulf Cooperation Council markets, particularly its bonds, are looking more attractive as well**, though for different reasons. After rallying strongly this year on the back of higher oil prices and

After a stellar year-to-date, the AAC has taken profits on its overweight China position

the general risk-on mood, assets in the region have been hit in the past two weeks amid fears of an escalation of animosities between the US and Iran.

The yield premium on the ICE Bank of America Merrill Lynch Middle East and North Africa bond index has increased 24 basis points in may so far, as the US sent a warship to the Persian Gulf and a series of attacks on Saudi Arabian and UAE oil transportation infrastructure heightened the tensions in the region.

The additional yield comes on top of what are already good rewards for bonds in the region when compared to similarly-rated securities from other markets. Some bonds of oil-producing countries in the GCC boast high ratings but are less volatile and pay better yields than their EM peers in part because of the geopolitical concerns which linger over the region. They are also highly correlated to oil prices, which remain in an uptrend, after being depressed for a few years.

The cost of a barrel of Brent crude fluctuated last week but still ended the week up by 2.25%, as worries about tensions with Iran offset a 5.4 million barrel rise in US crude inventories. With demand in developing nations waning and output in the US continuing to increase, crude markets seem fundamentally balanced. However, the cushion for a major disruption is thin and there would not be enough oil elsewhere to compensate for it if the flow of oil from the Middle East is impacted.

While a significant conflict in the region still seems unlikely, the threat remains, which should support oil prices staying within the US$60-80 range that Brent crude has exhibited since February, which ultimately supports the performance of GCC assets.

GCC bonds are offering even better relative yields after geopolitical issues prompted a correction in the asset class

One of the countries that could suffer from the double whammy of higher oil prices and heightened aversion to emerging market risk is India. Crude prices impact the country's trade balance and often filter through to the rupee and into inflation. That could hamper the Reserve Bank of India's ability to continue cutting interest rates. Stocks in the country had rallied until the end of April, partly as a reflection of a repricing of interest rates.

The Sensex Index was up 8.37% in dollar terms between 1st January and 30th April, but it has dropped 3.83% since the beginning of May. Part of that can be attributed to the Indian rupee, which is down 1% against the US dollar since the start of the month. The falling yuan could continue to weigh on the currency too.

Investors in Indian assets, however, will have at least one uncertainty removed this week, as exit polls on the world's largest democratic elections start to come in today. **A confirmation that the Bharatiya Janata Party will be able to form the government and that Narendra Modi will remain prime minister is likely to embolden global investors to return** to Mumbai markets. The final results are not expected for a few weeks however, and some investors could wait for them to be published before adding to their Indian bets, particularly amid the trade war issues.

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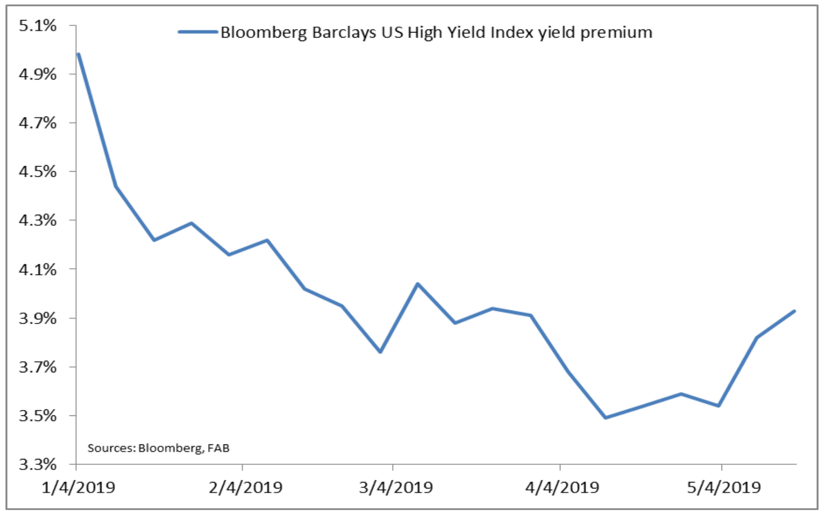
Weekly Theme: US high-yield starting to look attractive again

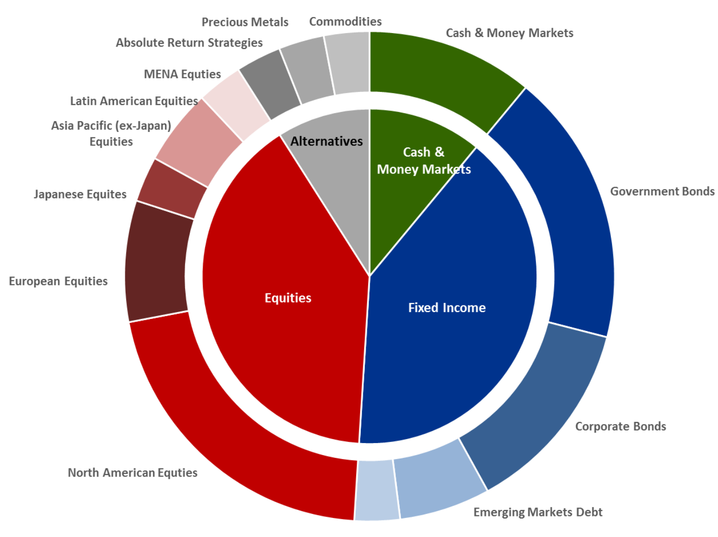
US high-yield bonds have a high correlation to US equities but face lower volatility. And after the recent sell-off, the yield premium they pay over higher quality bonds has made them even more attractive. The Bloomberg Barclays US Corporate High Yield index currently pays a yield-to-worst of 6.39%.

This is part of the reason why the FAB Asset Allocation Committee has decided to reduce its underweight in corporate bonds, and to express that change through incremental investment into US corporate high-yield.

Because these are bonds of highly indebted companies, the best way to approach the asset class may be through an investment in a diversified portfolio of bonds, such as a mutual fund, which can significantly reduce the impact of occasional defaults.



Current Tactical Asset Allocation



	Positioning	Detail
Cash	Overweight	In Cash & Money Markets
Fixed Income	Neutral	From underweight, adding US high yield
Equities	Neutral	Taking profits on successful China bet
Alternatives	Underweight	In Hedge Funds

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