The economy is fine, but watch out for politics

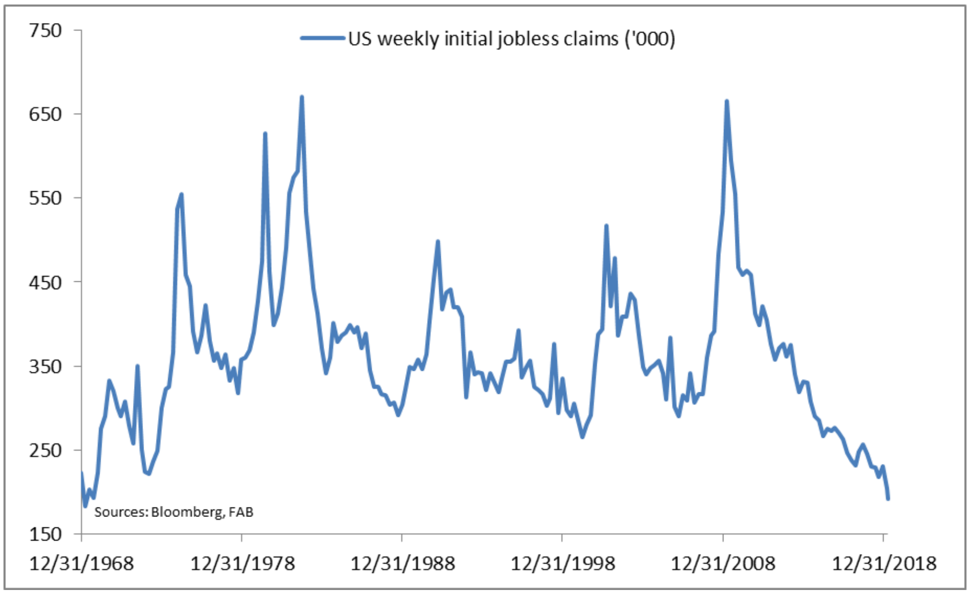
The US economy is just fine, and last week brought further indications of that. Initial jobless claims, which measure how many people are filing for unemployment welfare every week, dropped to the lowest in 50 years, while retail sales surprised positively. That comes on the back of a series of other positive data points over the past weeks. The main risk brewing now, however, is political.

While the markets digested the positive data last week, Washington D.C. was bubbling with chatter about the report former FBI Director and Department of Justice Special Counsel Robert Mueller wrote about President Donald Trump's dealings with Russia. A redacted version of the report published by Attorney General William Barr did not accuse the President of any crimes, but offered enough questions to empower more radical members of the Democratic Party in Congress to call for Mr. Trump's impeachment. It is unlikely they would be able to remove the President, given that they would need two-thirds of the Republican-controlled Senate to vote for the impeachment.

Instead, however, Democrats seem to be succeeding at irking the President, who fired a few angry tweets over the weekend about the investigation. With the 2020 election cycle having officially started off, Mr. Trump could react strongly to criticism and questions about Mr. Mueller's findings. The way those strong reactions manifest themselves could determine whether they become a boon or a threat to the current rally.

"President Trump's reaction to the Mueller report could help or upset markets."

One positive thing Mr. Trump could do is to try and speed up the resolution of the trade war with China to drive more positive coverage of his achievements while in office. That however, seems unlikely to happen within the next few days, given that trade representatives from both countries still have several meetings scheduled for May.



Instead, the President could increase the noise in the ongoing trade negotiations with Europe, something to which markets would probably react negatively. Similarly to China, Europe is likely to suffer more this time around. Germany reported last week factory output dropped for the fourth consecutive month, according to a purchasing managers survey. Manufacturing is the key activity in the EU's largest economy. Lack of economic progress has caused the rift that prompted another general election in Italy and helped spur the yellow vest protests rekindle in France. Adding a trade war with the US into that mix could hardly be positive.

However, the US is unlikely to get out of this one unscathed as well. In the previous trade dispute it was different. China exports some four times more to the US than it buys. The EU is a big buyer of American products and trade between the two blocs is fairly even. The US exported US$501 billion to the EU in 2016 and imported US$592 billion, according the Office of the US Trade Representative. In short, the US has as much to lose as the EU on this one.

Even the dispute with China, with which the US has a clearly uneven trade relationship, has not left the country unscathed. US farmers have reported significant losses this year from dropping commodity prices and lost sales resulting from the trade dispute. These people also happen to form an important political constituency for Mr. Trump, so his reelection bid may have suffered too, even if marginally.

The UK economy is perhaps the only one in the EU which may be better able to withstand an economic shock, if only Brexit were not an issue. Retail sales rose 1.1% in March, when economists expected it to drop 0.3%. The manufacturing PMI remained solidly in expansionary territory at 55.1 in March, the highest in more than a year. Unemployment is still at the lowest in more than 40 years. In fact, the Bank of England would have a hard time justifying its inaction were it not for the fact that inflation has surprised to the downside. In March, CPI came at 1.9%, just below the BoE's target of 2%, thanks, perhaps, to food prices being under control and the strengthening pound, which has rallied 2% this year.

As for China, the pain it endured as a result of the trade war is well reported, though the country seems to have turned a corner. Gross domestic product rose 6.4% year-on-year in the first quarter, beating economists' estimates. Factory output in March jumped 8.5%, much higher than forecast, and retail sales expanded 8.7%, while investment rose 6.3% so far this year compared to 2018.

The strength of the Chinese economy was part of the reason why the FAB Asset Allocation Committee (AAC) decided last Thursday to remain overweight in the country, while it reduced its exposure to Global Emerging Markets (GEM). The GEM reduction stemmed from concerns about the impact of politics in Turkey is having over assets in that country and how that could affect other developing nations.

"The AAC reduced its GEM exposure, while keeping overweight China, as risks related to Turkey increase."

The Turkish lira has lost 4.1% since the beginning of April, following fiery rhetoric by President Recep Tayyip Erdogan during local elections. Mr. Erdogan's decision to challenge the narrow victory of an opposition candidate for mayor of Istanbul and a squeeze on dollar liquidity that harmed foreign investors further undermined confidence in the country and accelerated the currency selloff.

However, last week, the Financial Times suggested in a story that the Turkish Central Bank may have severely depleted its foreign currency reserves while trying to prop up the lira lately, raising the specter of a more serious crisis.

While there is little evidence that such a scenario is impending, the risk it could pose to the broader emerging markets was enough for the AAC to pare its GEM exposure. Furthermore, the rising price of oil means that some of the countries that import the commodity — such as Turkey and India — could again come under pressure as their trade deficits begin to widen again, after having narrowed or even disappeared following the currency depreciation they suffered last year.

Brent crude is up 33.8% so far this year, having risen 12 of the past 16 weeks. At the Friday closing price of US$71.97, the commodity could start adding inflationary pressure across the world, and could be particularly detrimental to net importers. Unfortunately for these countries, there are few signs that oil's ascent will be checked for now. Last week, the American Petroleum Institute said that US oil demand hit the highest since 2005. The news came just as the number of active rigs in the country dropped, signaling that energy companies are keeping their promises of investing less and returning more money to shareholders. This news hit amid headlines suggesting the US could soon increase the sanctions against Venezuela and as fighting continued in Libya. Perhaps the only good news for oil bears last week was the fact that inventories in the US dropped less than expected, a piece of data that curbed the gains for the commodity.

"Higher energy prices could weigh on the currencies of oil-importing EM countries."

As oil increases, it could add pressure to the Indian rupee, the Turkish lira and the currencies of other oil-importing nations. That, in turn, pushes inflation higher and could reduce the ability local central banks have to cut interest rates, and hence slow these economies. Ultimately, the demand for oil itself, which was picking up this year, could fall again. This, along with high production of shale oil in the US are likely to weigh on oil prices eventually. For now, however, crude prices continue to climb.

Rising energy prices may hurt oil-importing nations but it is a boon for exporters, such as Indonesia, Malaysia and some of the Gulf Cooperation Council nations. This bodes well particularly for Saudi Arabian equities, which are seeing pent-up demand anyway. Expected foreign inflows from the country's inclusion in major global EM indices such as the MSCI and the FTSE have not been fully priced in and the average multiple for the nation is likely to increase in the future, suggesting it may be fairly valued or even undervalued. The country's inclusion in the FTSE EM index began to be implemented in March and a similar move in the MSCI index happens in May. A sudden rise in demand in that normally illiquid month could prompt a further rally. Furthermore, while most investors tend to 'front-run' index inclusion implementation, many global funds may have stayed away from the Saudi market last year due to political issues. That means flows that would normally have happened in 2018 were delayed and suggest there is room for a further rally in the Tadawul.

"Demand for Saudi stocks because of index inclusion along with higher oil prices could help MENA equities."

Indonesia could be set up for a rally too, after the country's general elections, one of the main political risks still hanging over the nation, were completed last week. Exit polls and preliminary counts indicated that incumbent President Joko Widodo won by a comfortable margin. The market celebrated the news with a 2.79% rally in the Jakarta Composite Index, accounting for nearly half the 6.36% in gains for this year.

Indonesian stocks have lagged other emerging markets partly because of uncertainty about the presidential elections. Mr. Widodo's main challenger, former military officer Prabowo Subianto, had gained traction in recent polls and it looked like he could stage a surprise win. Investors feared that his tenure might be less focused on implementing key reforms in the same way that Mr. Widodo's has.

The confirmation of another term for Mr. Widodo is likely to prompt more investment into Indonesian assets. However, Mr. Subianto's strength among voters may also mean that Mr. Widodo may be less reform-minded than he was in his first term, as he seeks to appeal to the voters who turned their back on him this time.

For inquiries related to this article, please contact:

Alain.Marckus@bankfab.com or Christofer.Langner@bankfab.com

From West to East

Weekly Investment View
21st April, 2019

Weekly Themes

MENA Equities	⇧	Index inclusion and rising oil prices are likely to continue to support stocks from MENA, with the exception of Turkey

AAC Strategic Position

ASSET CLASS		WEIGHT	
Fixed Income		**Slightly Underweight**	
	Corporate bonds		Underweight
Equities		**Overweight**	
	Asia ex-Japan		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

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