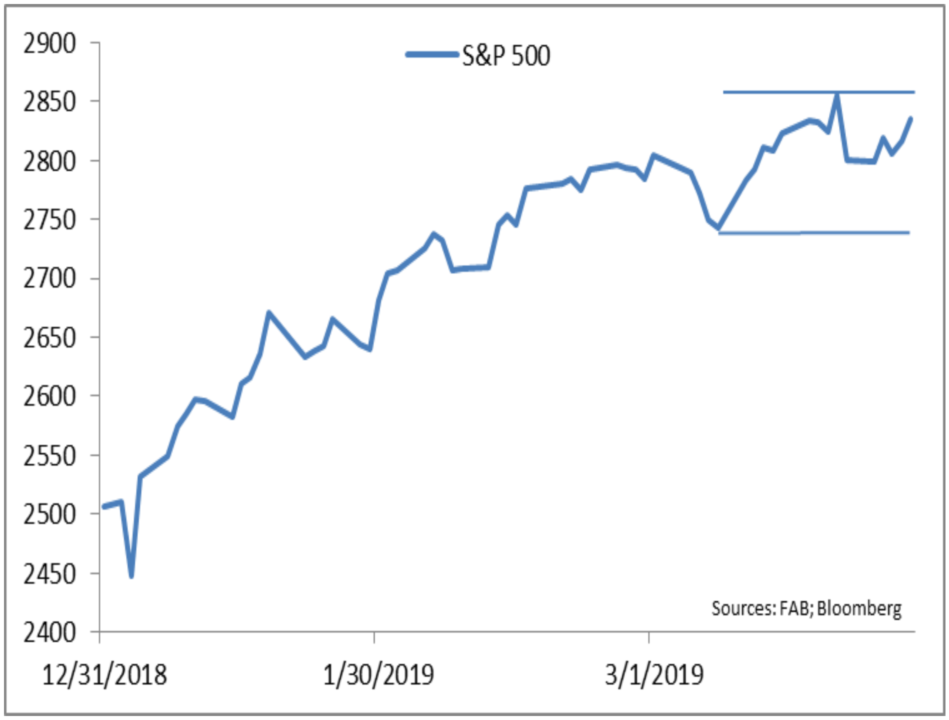
Lack of direction in markets may end with US jobs report

In some ways, the year is about to start. So far, 2019 has been about setting the record straight and correcting some of the exaggerated moves that happened in the end of 2018. With the first quarter over, investors are in a better position to take meaningful positions in various asset classes. Both economic data and market activity in the coming weeks will be crucial to define which way markets will go.

Since the beginning of March, equities have been trading sideways, with the S&P 500 failing to move beyond the 2,820 resistance. The stock gauge ended the month up by 1.8%, helped mostly by two days of gains of more than 1%, given that the index was down 11 of the 21 trading days of March. Similarly, the MSCI Emerging Markets finishes the month up by 0.68%.

To be sure, investors had good reason to be cautious. The S&P 500 had been up 11.1% in the first two months of the year and its first quarter performance is the best in about a decade. The MSCI Emerging Markets had risen 8.8%, a performance last beaten in 2012. That was after respective losses of 14.0% and 7.8% in the fourth quarter of 2018. However the air is now clearer. Valuations are not expensive as they were in some cases in the third quarter, and they are not as cheap as they ended the year. Accordingly investors are grappling with what to make of the future. They are unsure about the path of US growth, with many having read the sudden dovishness of the Federal Reserve in its last meeting, two weeks ago, as a sign that even central bankers are worried about lower growth in the world's largest economy.

There may indeed be some reason for concern. Last week, the Bureau of Economic Analysis revised its fourth quarter US GDP growth estimate to 2.2%, from 2.6%, largely due to a drop in consumer spending. That change reduced overall growth for 2018 to 3%, from 3.1%. There are signs that the



reasons for the revision carried into the first quarter too. Consumer spending eked out a 0.1% gain in January, while personal income dropped by that much, and disposable income fell 0.2%, the BEA said last week. The data, coupled with the unexpected miss in the February jobs report, signal that the economic slowdown was real.

Whether it was strong enough to push the US down a recessionary path will become clear this Friday, when the US Bureau of Labor Statistics reveals nonfarm payroll numbers for March. The median estimate of economists surveyed by Bloomberg points towards a gain of 178,000 jobs. That is slightly more than the 170,000 new positions originally forecast for February, when the US created only 20,000 new jobs.

"Investors may start pricing in a recession if the US jobs report misses estimates."

If any miss, however, is not as big as the February one, investors are likely to shrug off the news. There is still plenty of reason to be positive about US growth, which is expected to remain at a pace of about 2% this year.

Meanwhile, the rest of the world is catching up, too. Multiple rounds of stimulus in the past year have started to feed into the Chinese economy, for instance. On Sunday, China's manufacturing purchasing managers index came in at 50.5, a number that signals a small expansion in the sector. It is the first 'positive' number since November, and marks a reversal of a downtrend that began last May.

Manufacturing remains the most important part of the Chinese economy, having been responsible for 43% of the nation's GDP expansion last year. The next most important sector, real estate, is also getting a boost, with some of the tightening measures seen in the past few years starting to be reversed. The news suggests FAB's expectation that

China will grow at a similar pace to last year's, against the consensus of a 6.2% expansion, could yet prove correct. That suggests Chinese asset prices could have further room for gains.
That may sound like a tall order, particularly after the CSI 300 stock index rose 31.8% in the first quarter in US dollar terms, its best performance since 2007. However, in terms of valuation the index remains attractive. The 12.3x expected earnings at which the index is trading is still far from the 15.4x average of the past 15 years, or even the 12.8x average of the past five years. It also has not priced in potentially stronger economic growth in the country. Finally, the index has not priced-in a potentially positive outcome of a trade deal between the US and China much as US markets seem to have.

"A trade agreement with the US could boost Chinese markets further, but that may not happen soon."

While both sides said last week that talks have progressed meaningfully and have been "constructive", President Donald Trump said he is in no hurry to reach an agreement. He may have reason to wait, too. Being seen as rushing to a deal ahead of the 2020 elections would make the agreement an easy target for President Trump's detractors. Furthermore, announcing a more comprehensive deal later in the year would keep the triumph fresh into the election cycle.
There are also some hurdles which may be proving difficult to overcome. As appearances go, the Chinese cannot be seen to be simply accepting all American demands, and they have reportedly been resisting the fact that only the US would have enforcement mechanisms against non-compliance to the deal. Another sign that Beijing is mindful of how to portray the deal is the fact that Xi Jinping, the Chairman of the Communist Party, has not yet agreed to come to the US to sign the deal. He is likely to push for Mr. Trump to go to Beijing instead, and the two men may end up having to meet somewhere in the middle, literally, perhaps even in the Middle East, to please both constituencies.
An agreement is almost certain, however. Both sides have learned in the past year the potential cost of a trade war between the world's two largest economies.
That helps explain why the FAB Asset Allocation Committee chose to remain overweight in Chinese equities in the first week of March, when it made the tactical decision to move US equities to neutral, from overweight. The move was prescient, given that the CSI 300 Index rose 14.53% in March, outperforming the S&P 500 by almost 13 percentage points.
In a meeting last week, the FAB AAC held that overweight position, though it cut other overweight positions as it revisits growth expectations across the world.

"The FAB AAC reduced European and Japanese equities to neutral from overweight last week."

On the European front, the move was driven mostly by the lack of economic growth in the European Union, the impact of negative interest rates on the financial sector, and political uncertainty. While last week a German business confidence indicator posted a gain for the first time since August, it remains at the levels of three years ago, indicating that the largest European economy is ailing. Meanwhile, Italy, the fourth largest economy in the bloc, is showing signs of slipping into a recession. All this, while the UK, which still represents a quarter of the STOXX 600 Europe equity index, has seen investment nearly stop as businesses expect a definition of Brexit.
That, by the way, is nowhere near a resolution. On Friday, Prime Minister Theresa May's Brexit agreement was voted down for a third time, although by a lower margin than the previous ones. This has opened the way to talk of elections in the UK and potentially a long delay of its departure from the European Union, as a newly-seated Parliament renegotiates the terms of the divorce.
Parliament will vote what options it will adopt this week, but, simply put, there are two potential outcomes: a hard Brexit on 12th April (the option which has received most votes among Conservative members of Parliament, by the way), or a long delay, with new elections in the UK for both its own Parliament and for the European Parliament. The choices are, therefore, between enduring some sharp temporary pain next month, or the slow grind of the past three years, which has helped UK business investment contract the most since 2010 in January. The process has also taken a toll on other European economies, which rely on the UK for much of their trade and supply chains.
That is hardly supportive of European equities and helps explain why the FAB AAC took profits on the European overweight, after the STOXX 600 index rose 12.3% for the year-to-date, its best quarterly performance since 2015. The 10% return in dollar terms was last surpassed even earlier, in 2013. The outlook is hardly as rosy, not only because of the political uncertainty and the economic backdrop. Banks, for instance, the second biggest component of the STOXX 600, are likely to continue to suffer the effects of negative interest rates and could be an even bigger drag on the index.
The FAB AAC also reduced its position in Japanese equities to neutral, from overweight, for similar reasons. Banks there are also seeing mounting losses from negative rates. Economic growth in the country is not only slowing, but seems elusive. There are some reasons to be positive about Japan, to be sure, as unemployment is at the lowest in more than 25 years. However, the country has failed to make the kind of structural reforms it needs to jolt the economy out of its 30-year slumber, and there are no signs that this will happen anytime soon. This suggests that growth, and therefore equities, could remain underwhelming for now.
Otherwise, the FAB AAC debated the potential extent of contagion into other emerging markets from a sell-off in Turkish assets. Members were, indeed, concerned that funds affected by Turkey could reduce positions in other markets, but there was a feeling that any reaction would be temporary, given the outlook for many developing nations, and China's budding recovery.

For inquiries related to this article, please contact:

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

From West to East

Weekly Investment View

31st March, 2019

Weekly Themes

US High-Yield Bonds	⇧	A strong US jobs report could trigger a stock rally, which could boost high-yield. Weak jobs could boost bonds in general.
MENA Bonds	⇧	This asset class is offering better returns than its similarly-rated peers and could benefit from both spread tightening or a rally in US Treasuries.

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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