Investment Weekly

For inquiries related to this article, please contact:

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

First Abu Dhabi Bank

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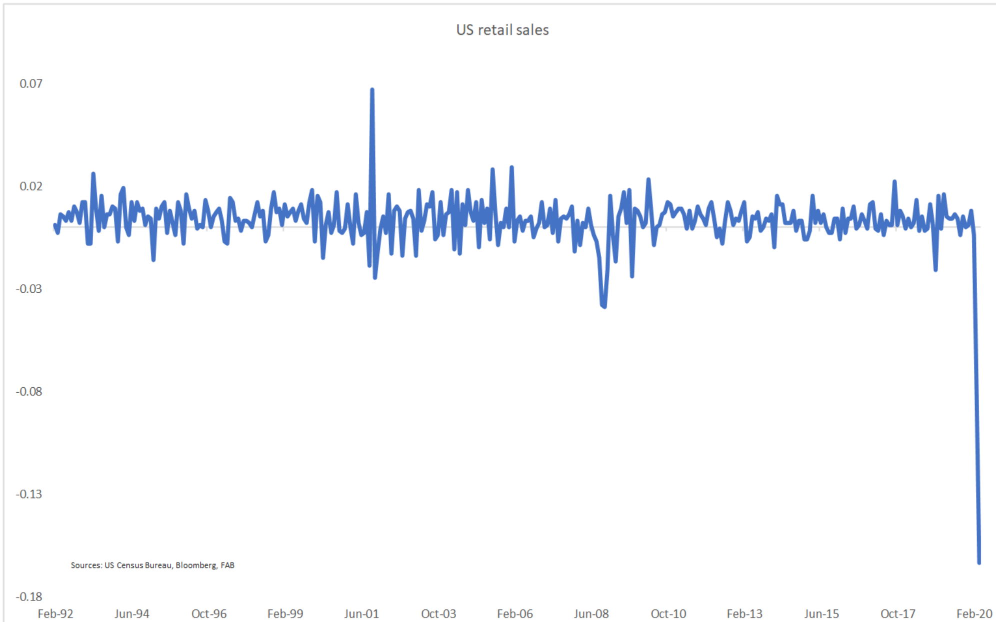
Markets now also have to grapple with politics



♦ US stocks had their worst week since March as a technical resistance held them and investors start to assess the political fallout of the crisis.

♦ The US has ratcheted-up criticism of China ahead of a key annual political meeting in Beijing, rekindling fears of a new trade war.

♦ US retail sales saw their biggest drop in history, adding to questions about how long it will take for the economy to recover from the effects of the pandemic.

♦ Donald Trump's approval ratings have fallen as state polls begin to show the possibility that Republicans may lose control of the Senate.

♦ The Democratic House of Representatives passed a US$3 trillion new stimulus package, but the Republican Senate has already promised to vote against it.

♦ The FAB AAC remains underweight in global equities and overweight gold.

Markets hate politics. It is generally hard to predict what elections will look like or what politicians will do to win them, and investors cannot model the uncertainty. Right now, however, investors are starting to grapple with the impact of the lockdown -induced crisis on upcoming elections in the US and across the world.

Washington, for one, is on fire. Last week, President Donald Trump's rhetoric against China became louder, as the latest polls showed his disapproval rating rising just six months before the November presidential elections.

The Trump Administration last week stopped the Federal Retirement Thrift Investment Board, a government workers pension fund, from allocating billions in investments to China as it was expected to. The Senate threw in its own message to Beijing as it discussed a bill to include Taiwan in World Health Organization talks on the virus. This was while an American destroyer crossed the Taiwan strait.

Taiwan is a particularly sensitive issue for China. Formosa, as it once was called, is in limbo, with China still claiming it as part of its nation, while the country itself has a completely independent administration and elections. Beijing tends to react strongly to any move that suggests Taiwan could be recognized as an independent nation, and bringing it to the WHO definitely qualifies as such. As if this were not enough, the Senate passed legislation that would impose sanctions on Chinese officials over human rights abuses against Muslim minorities.

Retail sales, one of the key growth engines of the US, saw their biggest drop on record

Then on Friday, Washington doubled down on its campaign against Chinese tech giant Huawei. The Trump Administration issued new rules that would block additional sales of semiconductors to China without the express authorization of the US Commerce Department.

The news came as chipmaker Taiwan Semiconductor Manufacturing (TSMC) unveiled plans to build a new plant in Arizona. TSMC could face hurdles selling chips to Huawei, deepening the discomfort. China responded by saying that it will defend the rights of its companies to purchase the materials they need and by threatening punitive measures against some US officials.

All this back and forth coming in the week preceding China's National People's Congress, which starts on 22 May, can hardly be good news. With all the eyes on Beijing, the nation's politicians are likely to step up the rhetoric themselves. The noise risks rekindling the trade war, too.

S&P Global Ratings last week said that it is unlikely that China will be able to meet the US$200 billion it committed to buy from the US in the preliminary trade agreement signed in January. That agreement was expected to be reviewed in October, and President Trump had vowed that if China was not meeting its end of the bargain, he might scrap it altogether. There now appears to be an increased probability that this will happen, given the proximity of the US elections and the general sentiment towards China.

For President Trump, scrapping the agreement, or at least getting tougher on China, could be a matter of his political survival. His promise to bring back manufacturing jobs from China was one of the drivers for his 2016 victory, as states in the so-called 'rust belt' such as Michigan, Pennsylvania and Wisconsin voted Republican for the first time in decades.

President Trump delivered to some extent, as the number of manufacturing jobs created in the first two years of his administration was higher than in the previous eight years. Yet, all those jobs have now been lost — and some. The latest evidence of that reality was offered by the Federal Reserve's April manufacturing report. Factory output fell 13.7% last month, the biggest drop on record. A week earlier, the Bureau of Labor Statistics showed that 1.3 million manufacturing jobs were lost in April.

The effect is being seen in state polls, where Republican senators face the possibility of not getting re-elected. Hence, even if President Trump is able to stay in office after the November elections, he may face a Democratic Senate. Attacking China may offer his best chance of turning the tables in the next six months.

Returning to his winning pitch also makes sense politically as the Democratic House increases the media barrage against the Trump Administration. Last week, the House passed a US$3 trillion stimulus bill that focused on helping states and cities, with priority given to those that were worst affected by the Covid-19 pandemic, which also happen to be mostly Democratic.

Perhaps sensing that the House was attempting to strengthen its support base, the Republican Senate vowed to kill the bill. In response, the Senate is instead proposing its own stimulus, which involves more tax cuts, something the House Democrats have promised to vote down.

The back and forth is likely to increasingly politicize the stimulus issue at a time when it is becoming more necessary. It appears that markets may still have to price in the expected delay of more stimulus and increased partisanship in Washington.

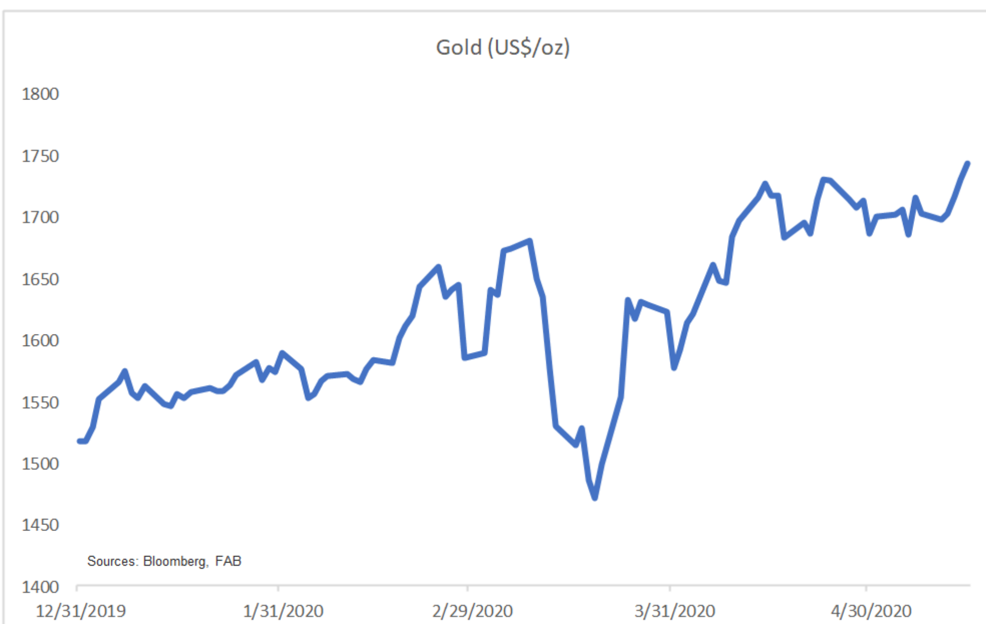
The emerging uncertainty was part of the reason why stocks sold off last week and gold rallied.

Gold prices have moved further away from a key resistance level, emboldening the bulls

It also confirms that investors need to remain cautious. Perhaps more importantly, the potential fallout of renewed tensions between the US and China could have an impact on a plethora of asset classes. Emerging markets, for instance, could suffer, given that any threat to Chinese growth tends to translate into collateral damage on most developing nations. Australia and New Zealand, similarly, could see further economic and financial weakness, given their dependence on China for exports.

In these countries the impact is likely to come first and fastest through the currency. China could once again use a weaker yuan as a weapon against the US. Indeed, 'redback' has weakened more than 0.5% in the month of May so far, breaching the 7.1 yuan per dollar level on Friday. To stimulate the economy and counter the US threat, China is likely to let the yuan weaken further, which could drag other EM currencies with it.

Gold is likely to benefit from the increased uncertainty. The yellow metal closed Friday at US$1,743.7/oz, the highest in eight years. Aside from offering a haven from volatility, the metal also benefits from record amounts of negative-yielding debt across the world, which make it more attractive as a store of value.



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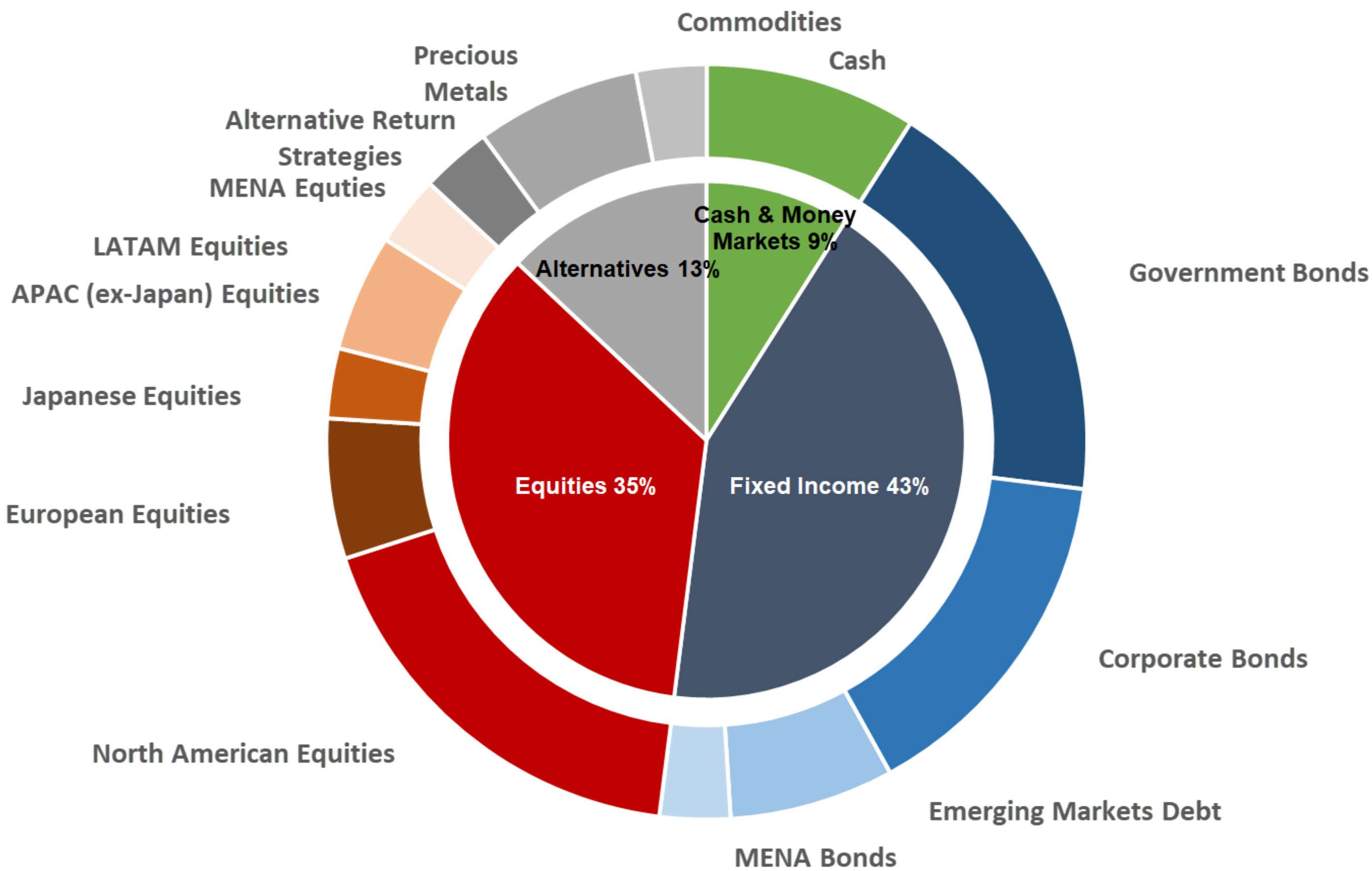
Current Tactical Asset Allocation



Asset Class	Positioning	Detail
Cash	Overweight	After taking profits on some equity positions.
Fixed Income	Overweight	Keeping slightly overweight focused on EM dollar debt and corporate investment grade bonds
Equities	Underweight	After taking profits on part of the US and European equity exposures
Alternatives	Underweight	However, overweight on precious metals specifically

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