Investment Weekly

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9 August, 2020

The bad news is there is lots of good news

♦ The US created 1.76 million jobs in July, beating consensus forecasts.

♦ The data suggests the US economy may be recovering faster than expected and this could complicate stimulus negotiations impasse in Washington.

♦ Although Democrats in the House have reduced their required stimulus amount, the Republicans continue to insist on a rather smaller amount.

♦ Amid the impasse, President Trump signed four executive orders on Saturday to extend some stimuli.

♦ While the move gives Congress more time to negotiate a new package, it may increase animosity between Republicans and Democrats and make an agreement harder to achieve.

♦ The growing uncertainty could foreshadow some volatility, after a recent good period for equity markets.

♦ The FAB AAC remains underweight in global equities and overweight investment-grade corporate bonds.

When markets become dependent on stimulus things can get complicated. For instance, good economic news could make additional stimulus to counter the effects of Covid-19 less likely, and have a negative impact on risk asset prices.

This happened at the end of last week, as the US Bureau of Labor Statistics revealed the US added 1.76 million jobs, beating consensus forecasts for gains of about 1.5 million. More importantly, the number of permanently lost jobs dropped for the first time since March.

The S&P 500 and NASDAQ Composite indices initially dropped on the news, the opposite of what would normally be expected. The S&P 500 later clawed back the losses and ended 0.06% up on Friday, but the NASDAQ remained in the red, closing the day 0.87% lower. Both indices still ended the week nearly 2.5% higher, boosted by gains earlier in the week.

The unusual negative reaction to bad economic news is not new. During the so-called 'Taper Tantrum' of 2013 investors watched warily for signs of economic improvement which might prompt the Federal Reserve to raise rates. Then, as perhaps now, good news was bad news.

In fact, the end-of-day rally of the S&P 500 happened amid noises about the possibility of President Donald Trump taking executive action to extend expiring fiscal stimulus. The President delivered on the promise yesterday, announcing a raft of measures to do just that.

While unemployment dropped, the percentage of the US population working is still low

He signed an executive order that defers payroll taxes for Americans making less than US$100,000 a year, allowed for US$400 extraordinary welfare payments to unemployed people for a few weeks, extended an eviction moratorium, and postponed student loan payments.

The package follows weeks of negotiations between the White House and Congress and debate between Republican and Democratic lawmakers about the make-up and size of a new stimulus bill. The Democratic-controlled House had already approved a US$3.5 trillion package nearly three months ago, but the Republican-controlled Senate shot it down, claiming that it was favouring Democratic states.

As late as Thursday, lawmakers from the two parties had still been at odds over the size of a new stimulus bill. Democratic leader and Speaker of the House, Nancy Pelosi, told reporters that her side had offered a US$2.4 trillion option, more than US$1 trillion short of their original plan, but Republicans had rejected it. Meanwhile, Republicans are aiming for a US$1 trillion package, which includes payroll tax reductions and lower welfare payments.

The two sides had established a Friday deadline to reach an agreement, which they missed. The risk now is that Congress goes into recess this week and only convenes fully again in September to continue negotiations. While lawmakers can still be called to vote on extraordinary bills (which may be the case if a new package is agreed upon) the lull creates the possibility that talks move even slower.

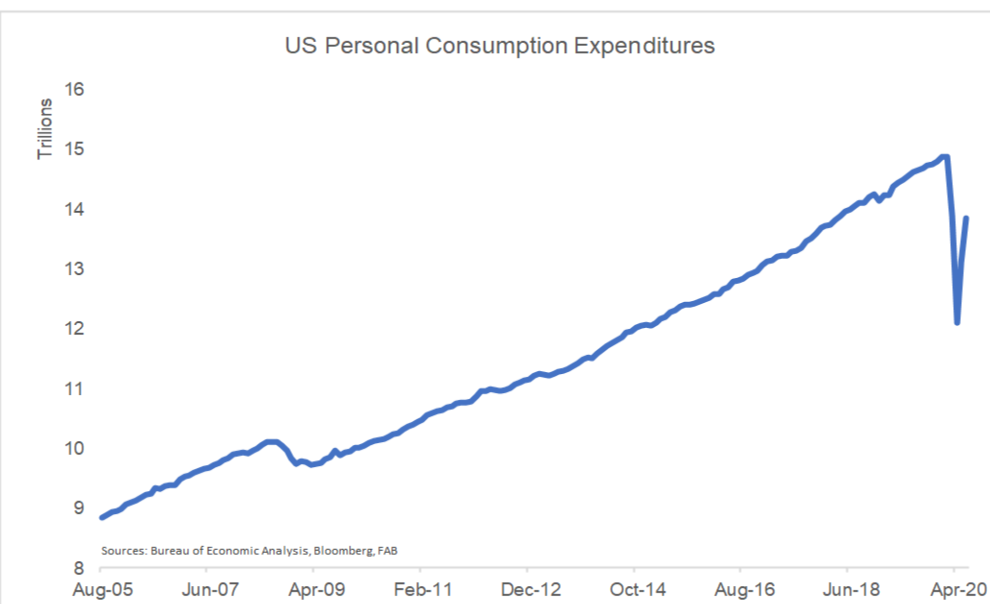
In that sense, the executive orders from the White House create a buffer allowing lawmakers to negotiate further. The trouble, however, is that only Congress has the ability to approve spending, so President Trump's orders could be challenged in court. The White House is probably banking on the possibility that the Democrats would not want to challenge a stimulus bill less than three months before the election, even if it is legally dubious.

While the Democrats may refrain from legal action, they are likely to be unhappy about the stratagem, especially since it could create the impression that President Trump has come to the rescue when Congress was dragging its feet. This could further separate the two parties in their negotiations and make more Congress-approved stimulus harder to achieve.

It is unclear what impact it will have on the elections, too. President Trump has been trailing the presumptive Democratic nominee Joe Biden in the latest polls, but has recovered some ground lately, after restarting daily media briefings on the coronavirus situation in the US. He still needs to make headway in a number of key states if he is to win re-election, according to polls, though.

The tricky part is that even if President Trump is re-elected there is a very significant probability that the Democrats could take the Senate, establishing full control of Congress, and of the nation's purse strings. That could mean four years of animosity in Washington DC.

Fiscal stimulus has helped US consumer spending recover quickly from its April shock



Should the uncertainty build up, and with many risk asset indices having approached all-time highs, it would not be surprising to see some volatility in markets in the coming months. That could reverse the recent downtrend in the dollar, even if temporarily, after the greenback lost more than 9% against a basket of currencies since 19 March. Indeed, the dollar index gained 0.7% on Friday alone.

If the dollar does strengthen, it could slow the bullish trend for gold, which benefits from a weaker greenback. Indeed, gold prices fell 1.4% on Friday, partly prompted by the reversal of the dollar.

However, Turkey may have also had some bearing on the move. The Turkish lira fell 4.2% last week against the US dollar, reaching all-time lows. The move was sparked by an unintended effect of a recent liquidity squeeze imposed by the Turkish central bank in a bid to control the lira's devaluation, which began in 2018.

Turkish banks are allowed to hold gold as liquid reserves — one of the few countries that allows that — and could sell gold to meet foreign currency payments if the lira continues to drop. More importantly, the Turkish central bank's foreign exchange reserves are heavily concentrated in gold.

As of 24 July, the latest data available, almost 83% of Turkish foreign reserves were held in gold, the highest such percentage in recent history. This means that if the Turkish central bank has to protect the lira it could be forced to sell some of its gold. Such a large seller could push down the price of gold, even if just temporarily. This happened in 2018, when the central bank sold some 5 million ounces of gold between June and October as it slowed down the lira's depreciation.

The FAB Asset Allocation Committee has recently reduced its overweight position in gold. It is still overweight, though. AAC members believed that with the price approaching US$2,000/oz there was an increasing possibility that the gold bull market had run too far, too fast.

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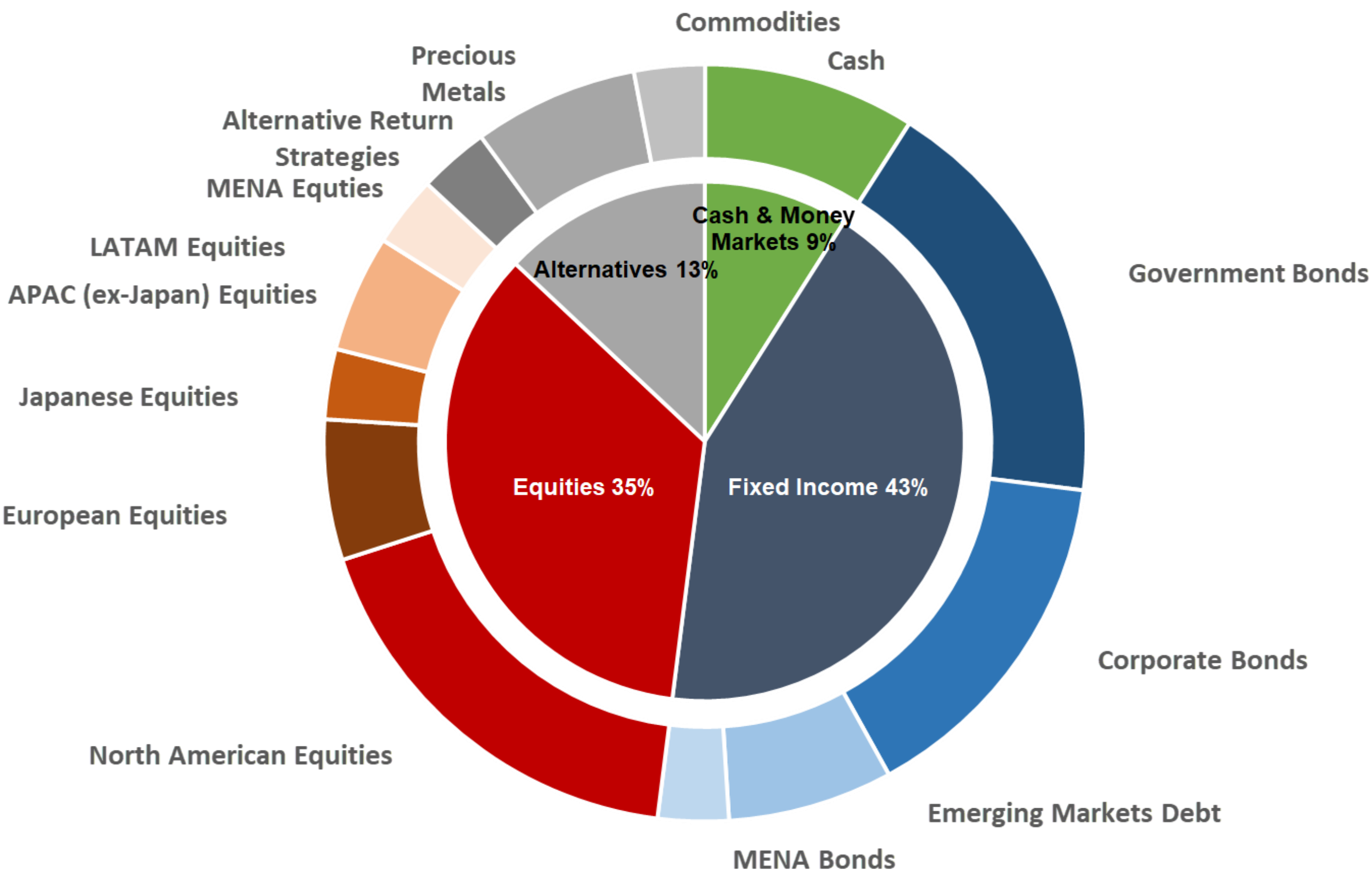
Current Tactical Asset Allocation



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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