Investment Weekly

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The economy is recovering nicely, but for how long?

♦ US retail sales of US$536 billion in July have brought the measure back to pre-pandemic levels.

♦ The weekly jobless claims in the US came below 1 million for the first time since 20 March.

♦ However, it seems like much of the recovery was spurred by fiscal stimulus and removing it now could hurt the recovery.

♦ In the meantime, the US Congress has failed to agree on a new stimulus package, with Democrats and Republicans still US$1 trillion apart.

♦ Lack of clarity about more fiscal stimulus may have slowed the upward momentum of US stock prices.

♦ Meanwhile, the US dollar continued to weaken, prompting some discomfort among other developed nations.

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

The world is not yet fully recovered but it is looking better by the minute. The economic data revealed last week showed that both the US and China, the world's two largest economies, are back on their feet, even if they remain feeble.

The question now becomes whether the economic recovery, particularly in the US, can continue at this pace as politicians may now feel under less pressure to add stimulus to their economies. And as investors ask themselves this question, the risk asset rally seen since the end of March has started to lose some steam.

In fact, it can still seem as though the economic reality and the markets are moving in opposite directions. Last week, the US Department of Labor announced that 963,000 Americans filed for unemployment benefits, the first time since March that the figure fell below 1 million. While that number had never been higher than 1 million before this year, it still represented an important positive milestone. It also came days after the number of job openings surprised to the upside in the US.

Perhaps more importantly, US retail sales amounted to US$536 billion in July, higher than the US$530 billion recorded in January, marking the return of apparent normality for this data, after it fell by a record 14.7% in April. Finally, inflation rose 0.6% month on month, double the rate of 0.3% that economists expected. These two statistics indicate that the most important part of the US economy, the consumer, is recovering fast from the March shock.

Retail sales, a key measure of the US economic health, have recovered to pre-Covid levels

Meanwhile, China's imports, an important measure of the health of its domestic economy, have increased 22.5% since their recent low in May. Exports from the country, a gauge of global economic health, have also turned positive for the year. To be sure, accumulated retail sales year-to-date in the country are still nearly 10% below where they were a year ago.

Even so, the general message is one of clear improvement across the globe. Yet, as the news has improved, stock markets seem to be losing momentum. The CSI 300 index of Chinese stocks ended the week 0.07% down, effectively unchanged, having gained only 0.27% in the previous week. So far the index is a mere 0.02% up in August.

US equities are faring a bit better, but not massively. The S&P 500 ended the week up by 0.64%, but had three negative days in five, the first time that has happened since mid-June. The story was similar for the NASDAQ Composite.

That may be partly explained by the fact that both indices are approaching all-time highs. The technology-heavy NASDAQ actually marked a new record of 11,108.07 on 6 August, from which it has now retreated 0.8%. Last week, the S&P 500 traded twice above its all-time record close of 3,386.15, reached on 19 February. However, the index retreated before the close and ended the day lower. It ended Friday a mere 0.4% away from its record.

The proximity of such a milestone so soon after the global economy suffered a very significant shock has perhaps prompted a pause among some investors. That is being reflected not only in the difficulty to mark new records but also in the trading volume, which last week was 13% lower than in the last week of July.

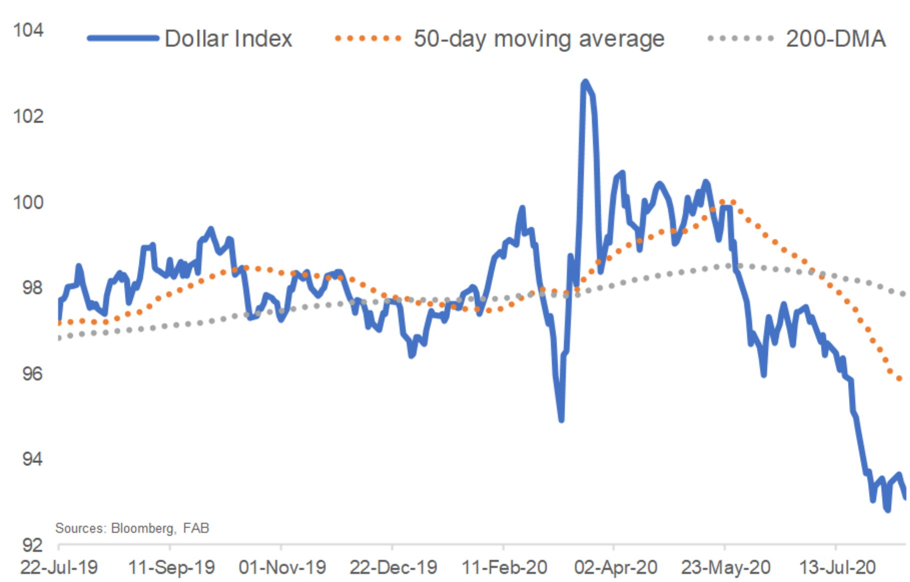
Aside from the technical hurdle, investors probably have also started to worry about the way forward for the global economy. In fact, all the recent good data may be more reason for worry than for comfort, depending on the point of view.

With the recovery well on track, politicians, especially in the US, seem to be in less of a hurry to add stimulus. Last week ended without an agreement on Capitol Hill for a new fiscal stimulus package, with Republicans and Democrats still US$1 trillion apart in terms of what they want (the Democrats want that amount more, whereas the Republicans want less). Were it not for President Donald Trump's executive action to extend some of the stimulus established in March, that lifeline for many Americans would have ended.

News over the weekend suggested that the two parties are so far apart that any agreement is unlikely to be reached or passed before September, when lawmakers return from the mid-year recess. This is a problem, given the clear correlation between government outlays and the recovery in consumption.

If politics in the US are murkier, at least in the Middle East there are signs of progress. Last week, the UAE and Israel established diplomatic relations, hopefully paving the way for peace in the region.

The US dollar index has dropped nearly 10% since its recent high on 20 March



Back in America, one of the engines of the recent recovery could also face hurdles ahead. The US dollar index, comprised mostly of its exchange rate against G-10 currencies, is down 3.9% year-to-date and 9.45% since 20 March, its recent high. This is part of the reason why US inflation, has started to pick up, logging a 0.6% rise in July compared to June, twice the 0.3% consensus forecast.

This, however, has translated in significant gains for some other currencies. The Norwegian Krone, for instance, is up 31.67% since 20 March. The advance has been so strong that some of the central banks of these developed economies have started to react.

After a nearly 15% gain in its currency, the Reserve Bank of New Zealand last week announced a surprise increase in its asset purchase program of 100 billion New Zealand dollars (US$65 billion), saying that prices for the country's "exports remain robust, but this has been partly offset by a rise in the New Zealand dollar exchange rate." A couple of days later, the Reserve Bank of Australia Governor Philip Lowe told lawmakers in Canberra that he would prefer a weaker currency.

It does not take much imagination to see the European Central Bank and other policymakers taking similar stances to boost exports. If that does materialize, it could weigh on the US recovery too, given its impact on American exports.

This, however, only points at more liquidity. A stronger dollar makes imports cheaper and reduces prices in the US. This could prompt even more aggressive action by the Federal Reserve to reignite consumer price rises.

The Fed may also have to counteract Congress' lack of action with more easing. More money sloshing around would likely once again feed through into higher risk asset prices. However, for now, investors could be well advised to take a step back to better see the fundamentals pan-out before getting excited again.

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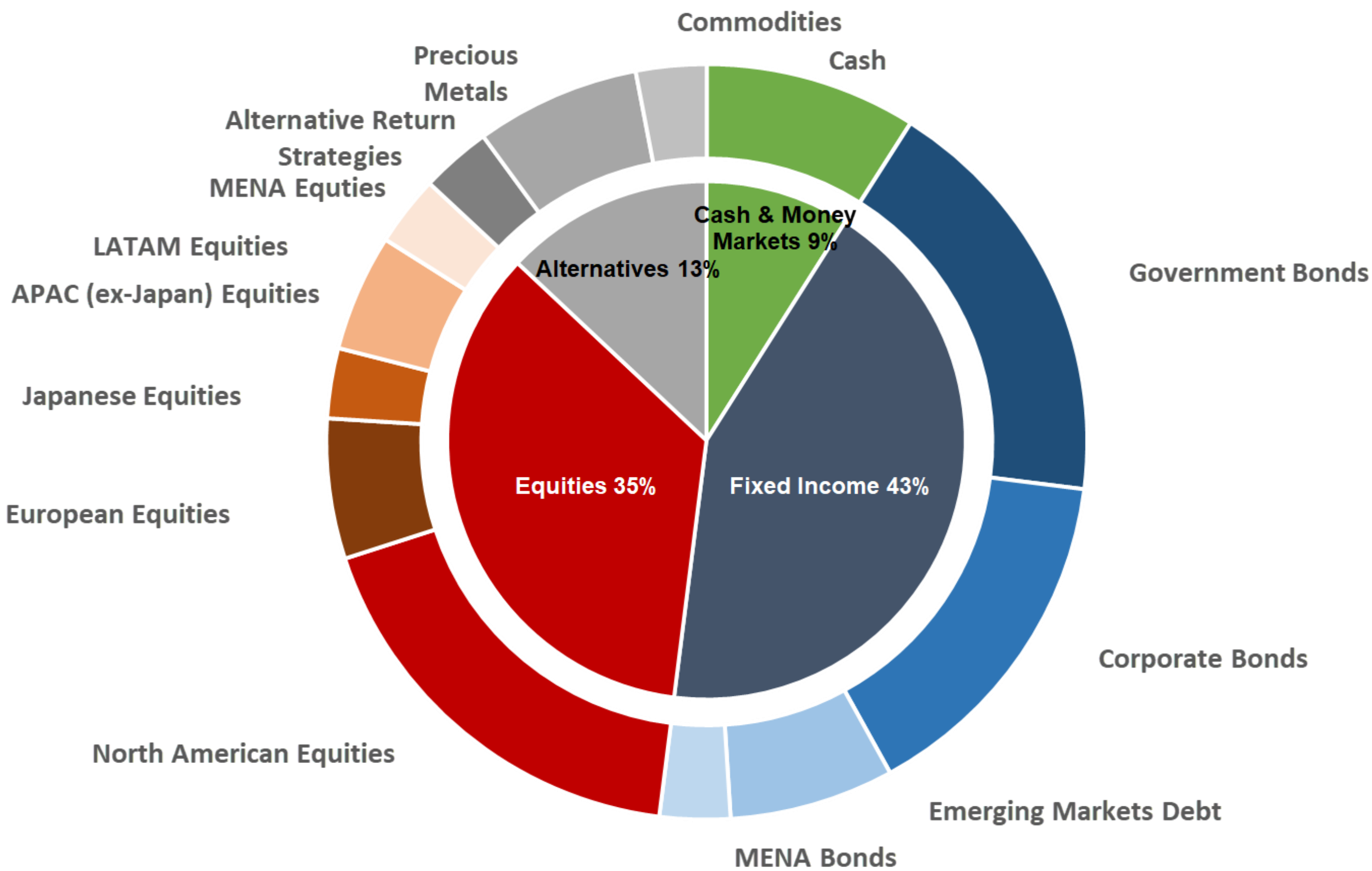
Current Tactical Asset Allocation



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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