Investment Weekly

For inquiries related to this article, please contact:

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

بنك أبوظبي الأول
FAB
First Abu Dhabi Bank

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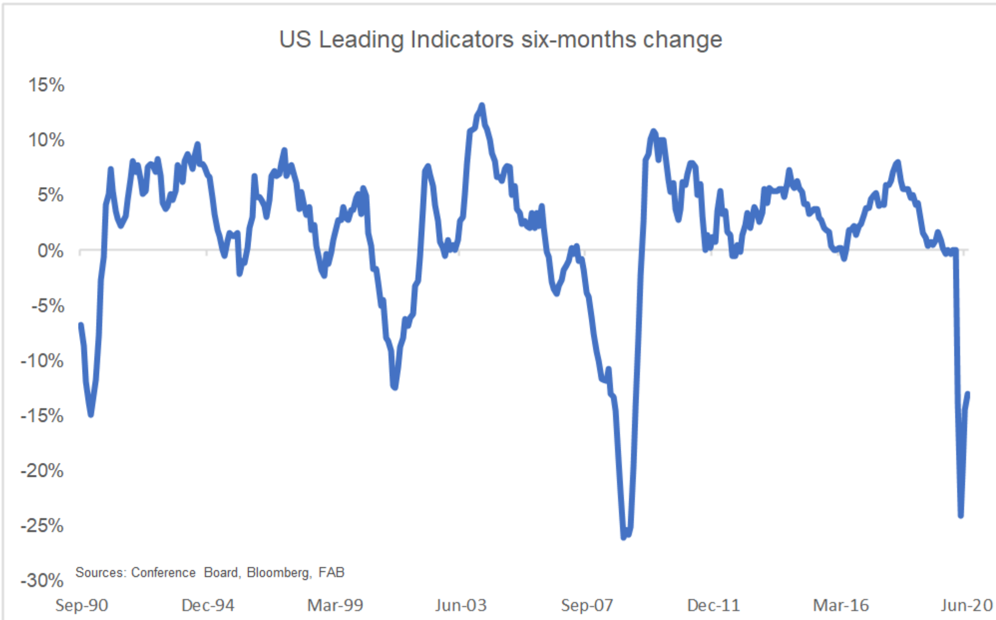
Balance sheet wars truce may give the market reason for pause

- **The Federal Reserve, Bank of Japan and Bank of England all meet this week and analysts expect no significant announcements from them.**
- **The European Central Bank may have set the tone for this last week with its lack of new policy action.**
- **The US dollar could continue to weaken as the world's key central banks stay put.**
- **However, investors could get wary as fiscal stimulus wanes and new Covid-19 cases rise again in many developed countries.**
- **The FAB AAC remains slightly underweight in equities, and overweight in IG bonds and gold**



Unusual monetary policy has become the norm in this world, to the point where traders across seem to be gauging the future path of markets from the potential for more stimulus or not. In that sense, they have been mostly disappointed.

The European Central Bank ended its two -day meeting last week without making any meaningful changes to its monetary policy, for instance. The closest to any action the Governing Council of policymakers came to was saying that they discussed the strength of the euro at length during their meeting.

The lack of any new measures pushed the euro higher by some 0.8% right after the meeting, though it eventually settled only 0.1% up on the day. This was an example of the dynamic described above: barring any additional stimulus, the weakening momentum for the US dollar continues.

Understanding this is important as three of the most important central banks in the world will meet this week. The Federal Reserve, the Bank of Japan and the Bank of England are all expected to do nothing beyond small tweaks in their statements after their policy meetings. Hence, the direction of markets in these three countries may remain unchanged.

The Fed, for instance, still has little reason to add more stimulus, given that financial conditions remain fairly loose. The US central bank does not pay much direct attention to markets but care about financial conditions, (the ability companies and people have to get money either through stock or debt), which is one of the key inputs to its economic models.

The Bloomberg US Financial Conditions index is at -0.012, very close to neutral and far better than the -6.31 extreme it reached on 17 March. From the Fed's perspective, there is little to see there.

The US leading economic indicators have recovered but are still below pre-crisis levels

In other words, the 10% and 6.7% drops in the NASDAQ Composite and the S&P 500 (respectively) over the past two weeks have probably not had the impact on the economy that would worry the Fed.

Not that it is all rosy. Several indicators are showing the economic recovery stalling. The Conference Board's Leading Indicator index, designed to foreshadow changes in growth, has been more subdued, moving up moving up 1.4% in July, after two months of 3% gains.

However, again, that was predicted by the Fed governors, which have consistently said that a quick initial recovery will be followed by a period when incremental gains will be slower.

Perhaps more concerning is the fact that the new Covid-19 cases are on the rise in much of the developed world again. Because the virus spreads more easily in colder environments, this is expected to become even worse as autumn advances in the northern hemisphere.

The number of weekly new cases in Spain, for instance, has accelerated to the point that it is now higher than it was even at the peak for the virus, back in May. The country reported 67,337 new confirmed Covid-19 cases last week, compared to 51,536 in the week ended 4 May.

A similar pattern is developing in other countries, though most remain below their all-time highs. Italy has seen the number of new cases on a weekly basis increase 293% since the start of September and last Friday, while the UK's numbers increased 242% in the same period.

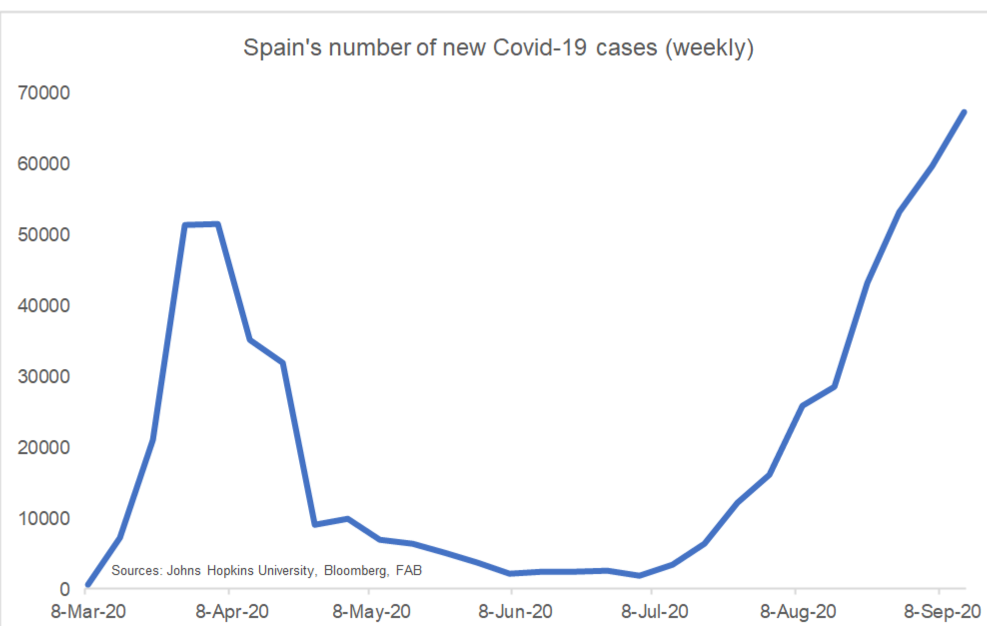
The rise has sounded the alarm and local lockdowns were reinstated in five UK cities. The moves are still short of a national lockdown, but indicate that restrictions could start to return. In fact, Israel was set to approve a new two-week lockdown today after daily new cases increased above 4,000 last week. The move prompted protests as the restrictions would happen during a holiday.

With the number of cases on the rise, many governments will have to weigh the popular pressure for no further lockdowns against the potential for a new spike in cases. Widespread closures such as the ones in April are unlikely partly because the measures have proven highly unpopular but also because one of the main threats that justified such stringent rules — the potential for healthcare systems being overwhelmed — seems to be less significant now.

Initially, doctors treated Covid-19 as they would respiratory failure (when a patient's lungs stop working), putting patients on ventilators early. However, a series of autopsies in April concluded that patients' lungs were fine. Instead, it was oxygen absorption in the blood that was being impacted by the virus.

This helped explain the initial high death rate for patients on ventilators and has led to changes in treatment. Doctors have also found some widely available drugs that help treat the disease and reduce the number of people in intensive care.

The weekly number of confirmed new Covid-19 cases in Spain is now at a record



Furthermore, part of the reason why the overall number of cases is increasing is because more people are getting tested and detection is now far better. Still, new restrictions are likely and that could impact the nascent economic recovery.

Oil prices have started to reflect this possibility with Brent crude dropping 11.6% in the past two weeks, closing at $39.83/barrel on Friday. Oil prices, however, are also reacting to data showing a rise in floating storage and supply when demand recovery could be about to stall. The commodity could face another headwind this week as Libyan factions have agreed to restart oil production.

To be sure, all these factors are likely to be discussed at length during an OPEC+ meeting set for this week, which could conclude with the group showing readiness to act again to keep oil prices under control. The message for the global economy, though, is less clear.

Ultimately, however, the 'central bank put' is alive and well. While the world's key central banks may pause for breath this month — and that, again, could be reason for the equity correction to continue for a bit longer— they are clearly committed to supporting the nascent recovery as much as possible. This means that any continued and sharp sell-off in risk asset prices will be met with more stimulus.

For emerging market investors, who is the biggest spender perhaps matters more than how much is being spent. Right now, the Fed continues to be ahead when it comes to printing money, which has translated into a weakening dollar. If, however, other central banks start to reverse that in coming months, the trend for the dollar could also change.

Overall, though, all the central banks are likely to continue to signal very accommodative conditions for the foreseeable future. This means that higher -yielding and high-growth assets will remain in favour, even if they suffer the occasional setback.

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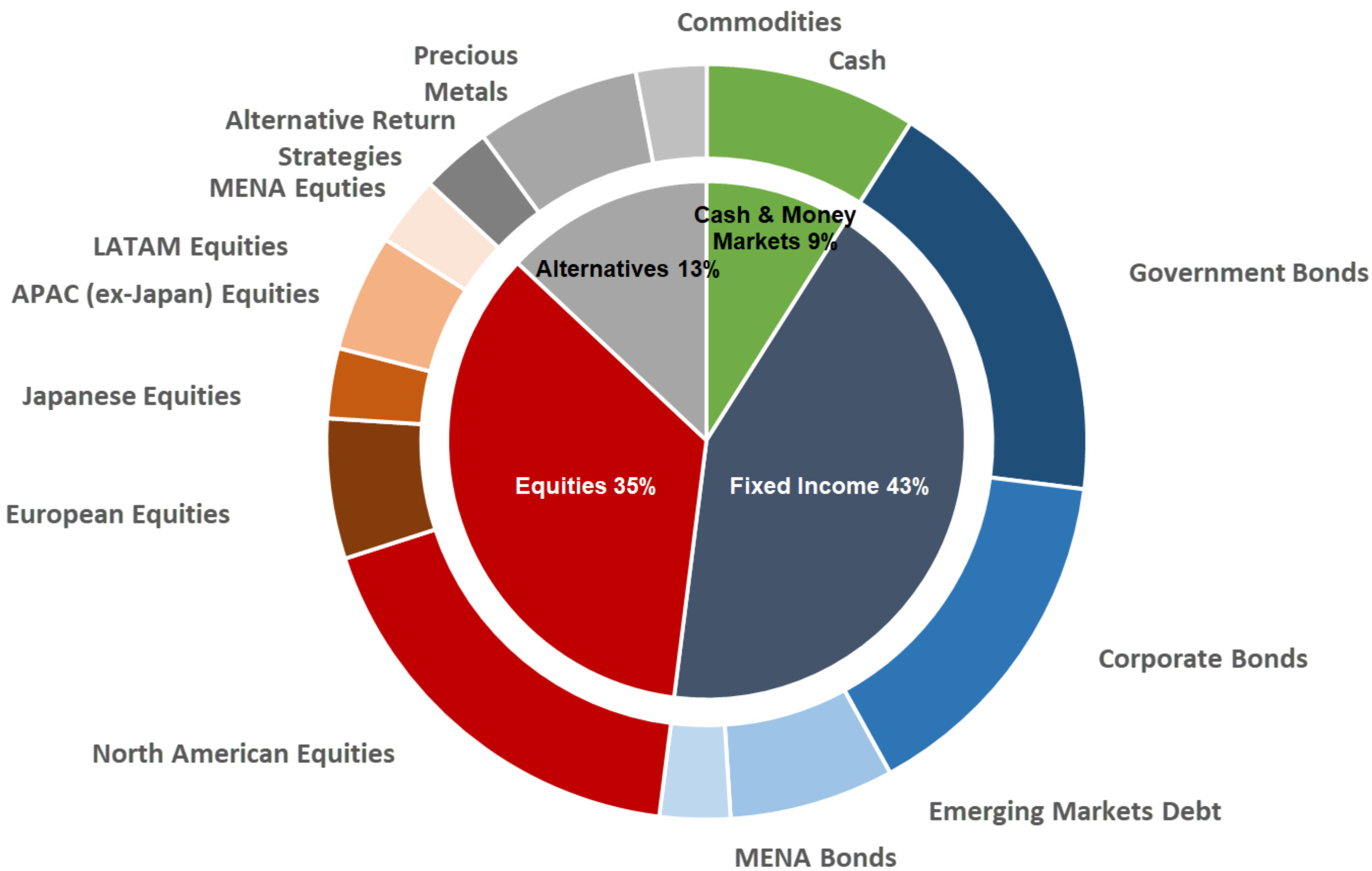
Current Tactical Asset Allocation



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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