Investment Weekly

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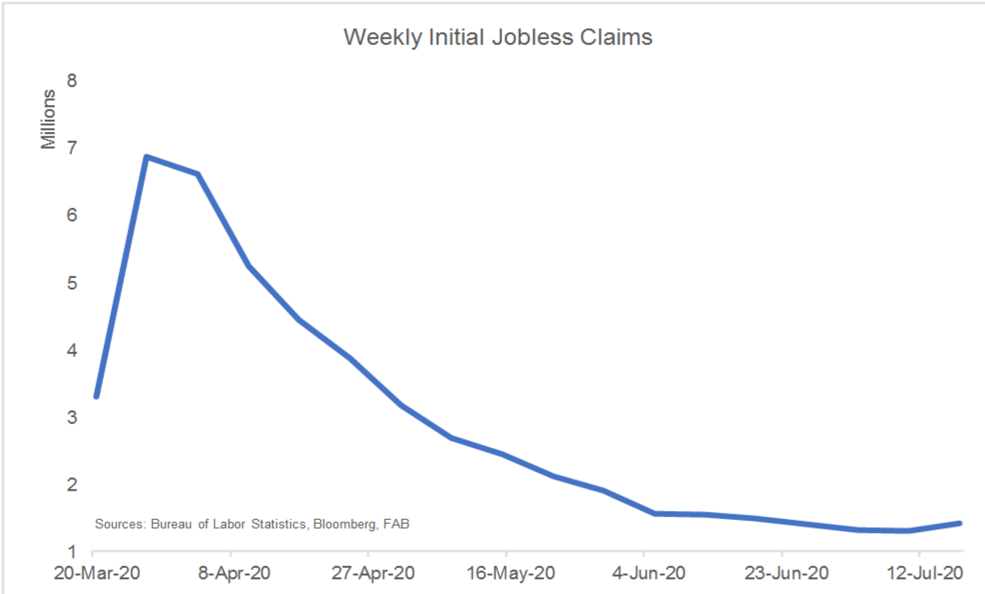
The US economy recovery shows fatigue ahead of Fed meeting



- **US initial jobless claims rose, after falling for 15 consecutive weeks.**
- **The S&P 500 had its first negative week in four as investors began to fret about the upcoming end of extraordinary welfare payments.**
- **The US Senate has delayed the presentation of a new fiscal stimulus package, and now risks being unable to have it approved before the US Congress goes into recess in August.**
- **All eyes will be on the Federal Reserve meeting this week, especially in light of questions regarding the above.**
- **The Fed's governors have indicated they still have tools to support the US economy.**
- **With nominal and real yields in dollar terms near record lows, investors are likely to continue to favour risk assets, and gold as a hedge against tail-risk.**
- **The FAB AAC remains slightly underweight in global equities, and overweight in investment-grade corporate bonds and gold.**

Long-term investors, particularly those in stocks, like to focus on whether things are getting better or worse, not simply on how good or bad they are. They look into the future, and the present insofar as whether what is happening is confirming their expectations, and the past when comparisons appear helpful. Accordingly the trend of economic data often matters more than the data itself.

The trend in US weekly jobless claims was improving for nearly four months, with most data points coming in better every week. However, 1.41 million Americans filed for unemployment benefits in the week ended 17 July, and that figure was higher than the 1.3 million median forecast by economists surveyed by Bloomberg. More importantly, it was higher than the number recorded a week earlier. Indeed it was the first time since 27 March that there was an increase in initial jobless claims. While economists had already started to predict a tapering of the downtrend, very few expected the trend to turn up again.

This data is collating with others to the effect that the US recovery is either stalling, or potentially reversing altogether. With the number of virus cases now rising quickly in several large states, such as California, Florida and Texas, and prompting partial shutdowns, it seems likely that the economy could falter.

In addition, investors now fear an additional risk: that the US Congress may be unable to respond to this wobble as quickly as it did in March. In fact, the worsening economic data is coming just as many of the programs approved then are about to come to an end.

After falling for 15 consecutive weeks, initial jobless claims in the US rose on Thursday

The risk may become more serious if Republicans and Democrats continue to bicker over who gets what. Two months ago, the Democratic-controlled House of Representatives passed a US$3.5 trillion new stimulus bill that proposed an extension of higher welfare payments (which end this week), as well as aid to states and municipalities.

The Republican Senate rejected that package and last week promised to share its own, smaller, package. However, the senators were delayed by negotiations with the White House, which wanted the inclusion of a reduction in labour taxes, which lawmakers of both parties refused to accept. Now, the problem is that both senators and representatives have very little time to approve any new package.

The US Congress is set to go into recess on 10 August and will only return on 7

September. It is not unheard of for lawmakers to vote on important bills during these periods, but it is uncommon. Ideally they would agree and pass a new stimulus bill in the next 15 days.

That would be a rare achievement. Even the US$2.2 trillion stimulus package approved in March took a couple of weeks to get through Congress, even with bipartisan support and the White House having no objections to the final text. The list of disagreements this time is long, and starts with the size.

As mentioned, Democrats want a new package to be some US$3.5 trillion in size, while Republicans are talking of a maximum of US$1.5 trillion. Then there is the issue of aid to local governments, which Republicans are stalling on, probably given that until recently the most affected states (and hence the ones likely to receive the most help) had Democratic governors.

While in normal times Republicans might have wanted to limit any legislation that favoured Democratic states, this becomes even more of an issue less than 100 days before a general election – and especially one that could see the Democrats take control of the Senate and maybe even the White House again.

The latest ABC News nationwide poll last week showed President Trump trailing his Democratic opponent Joe Biden by 15 percentage points. After wresting the House from Republicans two years ago, the Democrats also have a chance to take the Senate with 35 seats being disputed. The Senate currently has 53 Republicans and 47 Democrats, so there is a significant probability of a flip.

Ultimately, each party is likely to push its own deal, while blaming the other for insufficient action. Democrats already have an edge since they have already approved a package in May. Investors are starting to see there may not be agreement in Washington DC on a new package in time to plug the hole that the end of the last one will create.

This could provoke a correction in risk asset prices, after the market action on Thursday and Friday, with the S&P 500 dropping both days and ending negative on the week for the first time in a month. The US dollar continued to fall last week, by a further 1.6% on its index, to 94.435.

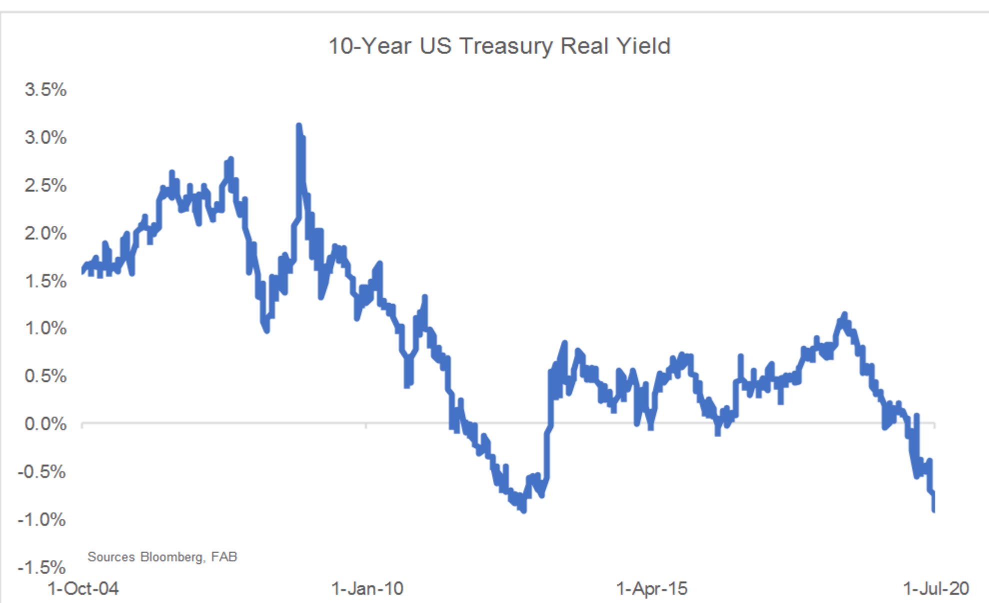
The weakness in the dollar helped gold prices end last week above the 5 September, 2011, previous all-time closing high of $1,900.20/oz, at $1,902.02. This took its year-to-date appreciation to 25.4%. In the past year, the metal has gained 33.4%, rallying even when the US dollar was strengthening, and despite one of the biggest drops in jewelry demand in recent history. These factors suggest that investor demand has been very strong, and we expect this to continue.

The real yield on 10-year US Treasuries was at –0.91% on Friday, near its lowest ever

Also likely to be part of the logic for gold is that the real yield on 10-year US Treasuries (i.e. adjusted for inflation) dropped to negative 0.90%, near the lowest in history. Not only is gold in a strong technical uptrend, but the general hedging reasoning for holding it remains intact. Indeed the case for other risk assets is not too different: with negative real yields and nominal returns on the 10-year US Treasury below 0.60%, there is no alternative — an expression that has become so common on Wall Street that many now use simply the acronym TINA.

There appears the likelihood that if investors start trying to reflect any worsening of the economic backdrop in risk asset prices, they will once again come up against the Federal Reserve. The central bank has a policy-setting meeting this week and although investors expect no significant news from it the Fed's governors have been saying they still have many tools available if they need to intervene in markets again, including yield curve control.

Prescient investors know that they need to focus on the future and on the trend, and they also know that the Fed always wins. Hence, if risk asset prices do start slipping, the US central bank is likely to once again act to preserve and protect the economic outlook, even if Main Street is looking increasingly at odds with Wall Street.



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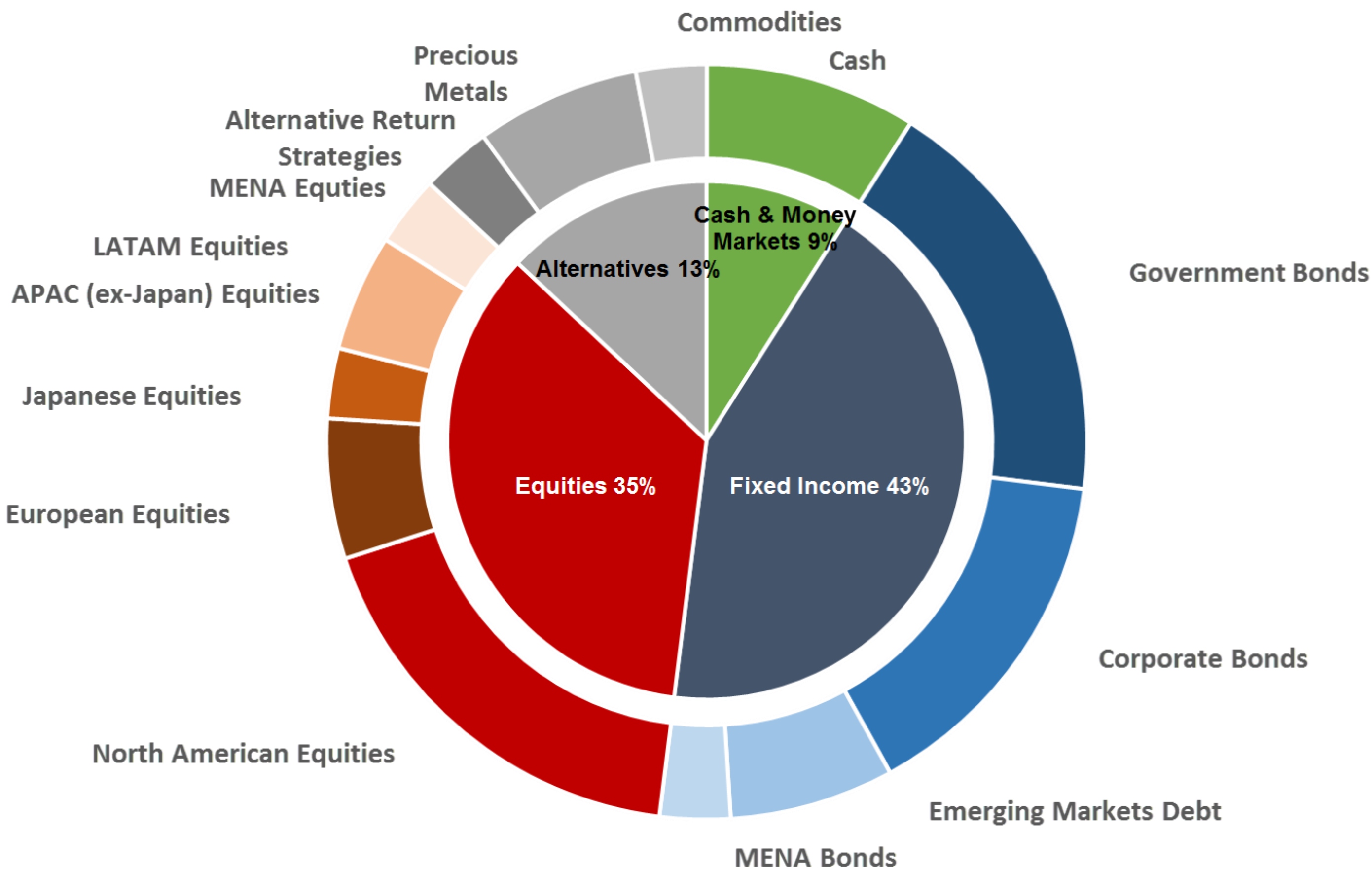
Current Tactical Asset Allocation



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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