Investment Weekly

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Fading uncertainties pave way for further equity gains

- **The US and China sign much-awaited phase one trade agreement, easing uncertainty about relations between the world's two largest economies.**

- **The US removes 'currency manipulator' tag from China as the yuan rallies 3.4% over three months.**

- **A stronger Chinese yuan supports EM currencies, which continued to rally last week.**

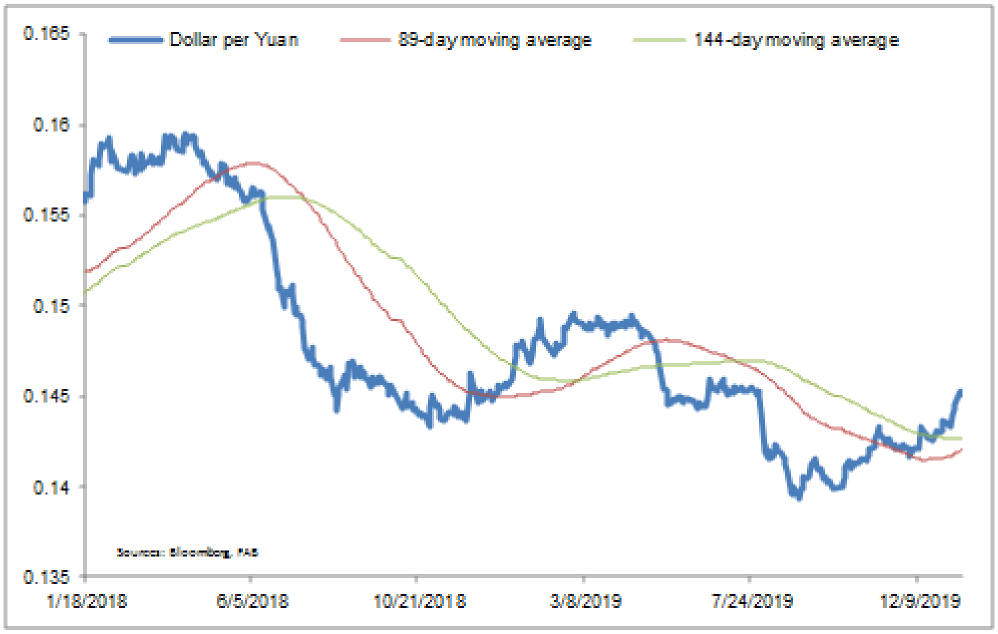
- **EM dollar-denominated bonds have room to gain as yield premiums remain relatively high.**

- **US Treasury yields rise as the country announces it will be selling 20-year bonds again for the first time since 1986.**

- **Gold prices retreat as volatility subsides, although the yellow metal remains in an uptrend.**

Last Tuesday, news outlets began to report details of the US-China 'phase one' trade agreement, due to be signed the next day.

The stories initially suggested that the US would keep in place most of the tariffs it had already imposed on Chinese products. Commentators questioned what China was ultimately gaining with the agreement in that case and markets began to price-in the possibility of a repeat of last May, when a seemingly imminent agreement fell through at the last minute. However, the positive news flow quickly overshadowed the doubts about the trade agreement, and risk asset prices quickly began to recover.



Also last Tuesday, the US removed the 'currency manipulator' label from China. While the move was mostly symbolic, it sent a clear message that the US was willing to compromise to reach a deal with China.

That change had little practical effect on China (countries labeled currency manipulators are barred from bidding in government contracts in the US, but Chinese companies hardly ever do that anyway). It did, however, give the Chinese yuan a boost, pushing it to its highest in nearly six months.

The currency has appreciated 4% since the 26 September, when the first signs that the US and China would reach a phase one agreement appeared. That helped other emerging market currencies rally as well, and the MSCI Emerging Market Currencies index has gained 3.8% in the same period, while the US dollar index has fallen by 1.5%.

The yuan has strengthened some 4% since September, helping buoy EM currencies

The Chinese yuan proceeded to gain further on Wednesday when China, represented by Vice-Premier Liu He, and President Donald Trump convened in Washington to sign the phase one agreement.

Indeed, as the news stories had indicated, the US kept tariffs on US$360 billion of goods, limiting its initial compromise to a cut in duties for US$120 billion of Chinese imports to 7.5% from 15%. While that may seem like little to write home about, President Trump will visit China soon, something that could be construed by the local media as a concession by the US leader, given that Chinese Premier Xi Jinping has resisted going to the US to sign the preliminary trade agreement.

The US also promised to start cutting the tariffs on the remaining US$360 billion of imports after a review of the progress in the first phase of the trade agreement, due to start around the time of the US election on the 3 November. The timing generated a significant amount of commentary, given that it leaves President Trump the option of ratcheting-up pressure on China ahead of the polls.

This suggests the issue of the trade war could still come back to haunt markets as the year progresses. China has already felt the impact of that policy, which helps explain why the country was willing to sign the phase one agreement, even before the US compromised more significantly. Last week, China announced that its GDP grew by 6.1% in 2019, the slowest rate since it began to publish the numbers in 1990. That was partly driven by an 11% drop in the country's trade with its biggest trading partner, the US. President Trump seems to have understood the importance of that and turned it to his advantage, and he could do so again in the future.

For now, however, President Trump seems to be happy with what seems to be a pre-electoral victory. China has committed to purchase some US$200 billion of goods and services from the US in the next two years. That includes about US$50 billion in agricultural products, and a similar amount in energy products (including crude oil). These two parts of the deal are likely to please President Trump's electorate in the US Midwest and Texas, which have been suffering from the trade war.

The agreement also calls for China to import more manufactured goods from the US, as well as services, like travel and insurance. In fact, one of the milestones achieved in the agreement was the removal of many of the barriers for American financial companies to operate in China.

Credit card issuers and insurers will be better able to operate in China under the new framework, and there will be fewer restrictions against US banks trying to own and operate lenders in the Asian country. Altogether, the agreement foresees Chinese imports nearly doubling from current levels. These measures add to a more constructive view of Chinese markets, and in the aftermath of its asset prices being held down by the trade war.

China's trade with the US fell by 11% last year, the worst drop since the 2008 crisis

The closing of the trade deal prompted risk assets to stage a rally last week. The S&P 500 gained 2% in the week, finishing on Friday at a record 3,329.62, while the tech-heavy NASDAQ index rose 2.3% in the week, ending at a new all-time high of 9,388.94. The two indices have been buoyed by the so-called 'January effect', when some investors who may have sold some stock in December for tax reasons return to the market, and from the removal of the trade war uncertainty.

US stocks also got a boost from the first full-year earnings reports which began to come through last week and generally painted a positive picture for corporate America. Of the 10 financial companies that reported earnings last week, for instance, seven beat analyst estimates. The initial figures prompted some analysts to start revising up their earnings estimates for this year, which should support more gains in US stocks.

The S&P 500 is currently trading at about 19.1 times expected earnings for the next 12 months, a level which is higher than the 17.7 times five-year average. A higher forecast P/E ratio can sometimes foreshadow a correction or suggest that the index has little upside ahead. However, that number can come down if analysts become more bullish about their growth expectations.

That seems to have started to happen. Economists seem to have begun to consider that the world could grow faster than expected this year as central banks continue to add liquidity to markets, and as some of the uncertainties (such as the US-China trade war) are reduced. Indeed, there is reason to believe analysts have been too bearish. The Citigroup Global Economic Surprise index has recently turned positive, a sign that actual economic numbers are coming in better than forecast.

One number that underwhelmed last week was inflation. The US CPI was down to 2.3% year-on-year in December, when the Bloomberg median forecast was for a

2.4% increase. That helped US Treasuries rally on Tuesday, just as markets were getting concerned with a potential restart of the trade dispute between the US and China. The slower pace of consumer price increases seems to have some investors increasing their expectations of another rate cut by the Federal Reserve this year. Fed funds futures are still pricing-in a 20% probability of a cut by January, 2021, though FAB's base case is for the central bank to stay put.

Treasuries reversed the gains later in the week anyway, as the US announced it would restart the issuance of 20-year bonds, which had been discontinued since 1986, when the country introduced its 30-year offering.

The prospect of some US$80 billion more a year of US debt, however, caused yields to increase across the curve. Besides, the signing of the trade agreement should also prompt some economists to recalculate the potential for inflation to increase as the US dollar weakens, and that may have played a part in the rise of Treasury yields towards the end of last week.

This potential inflation, if it does materialize, is unlikely to translate into higher Fed rates any time soon, however, as the central bank governors have made it clear they would rather let inflation run hot for a while before increasing rates. Rising prices, however, could be supportive of some commodities, gold and oil in particular.

Oil is already likely to benefit from the higher growth expectations, but the increased anticipated Chinese purchases of the commodity are also likely to impact its price positively. The commitment to buy more US oil and oil products could also reduce the price difference between West Texas Intermediate (WTI) crude and Brent. The latter has been trading at a higher value than WTI partly because of infrastructure issues which have made it cheaper for US producers to sell some of their oil domestically rather than export it. That could change as China replaces some of the globally-sourced crude for American oil to meet its commitments to the trade deal.

Gold could also benefit, but more from the perspective of higher growth and the prospect of a weaker dollar. The yellow metal again rose last week when volatility increased on Tuesday, though it still ended down by 0.3% for the week. The short-term drop was to be expected, given that volatility subsided as a result of the reduction of the trade uncertainty, but gold continues to be in an uptrend. Furthermore, the metal's recent spike pushed its price beyond two standard deviations away from its 89-day moving average, and some retracement closer to the mean was natural.

As the FAB Asset Allocation Committee has said since the third quarter, such dips are good opportunities to add some gold to portfolios as a hedge against potential bouts of volatility to come.

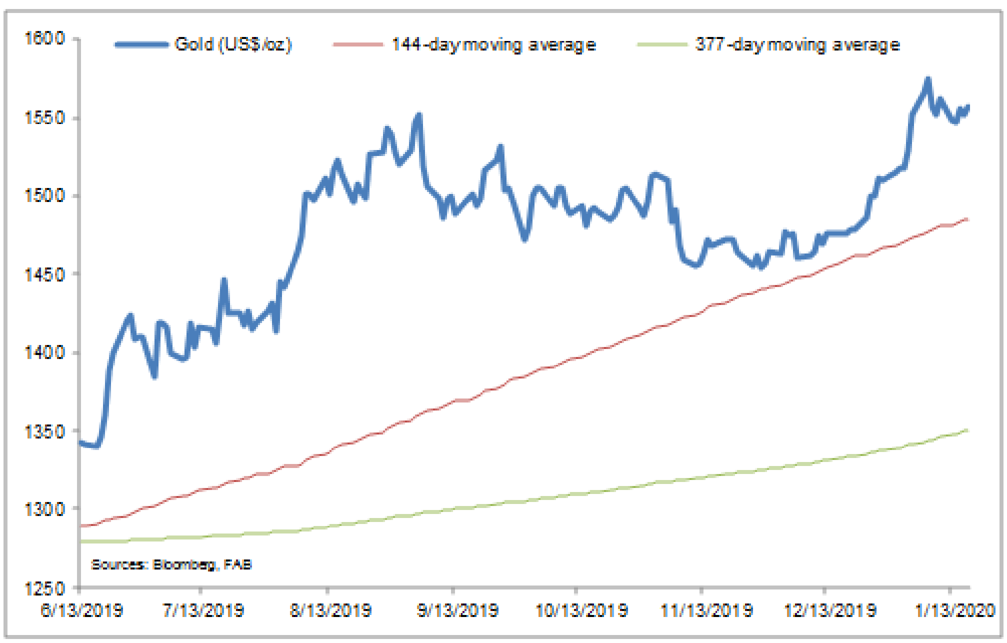
A similar approach could be applied to the British pound, which seems to have moved into an uptrend since the Conservative Party won a significant majority in the British parliament in December's general election. The currency, however, has seen recent bouts of depreciation as investors grapple with louder rhetoric from Downing Street.

Prime Minister Boris Johnson's cabinet seems intent on sending a clear message to Europe that the UK does not intend to follow the European Union's rules after a trade agreement is reached with the bloc.

On Saturday, UK Chancellor of the Exchequer, Sajid Javid, reiterated the message clearly in an interview with the Financial Times in which he said: "There will not be alignment, we will not be a rule-taker, we will not be in the single market and we will not be in the customs union — and we will do this by the end of the year." At the same time, Mr. Javid signaled he might start negotiating a trade deal with the US before reaching an agreement on Brexit terms with Brussels.

While such an agreement may hamper the negotiations with the EU, it may also give some confidence to investors looking to return to the UK. As China has shown, the US remains the world's biggest market and one of the most important to have a trade agreement with.

Gold prices retreated last week but remain in an uptrend and are a good volatility hedge



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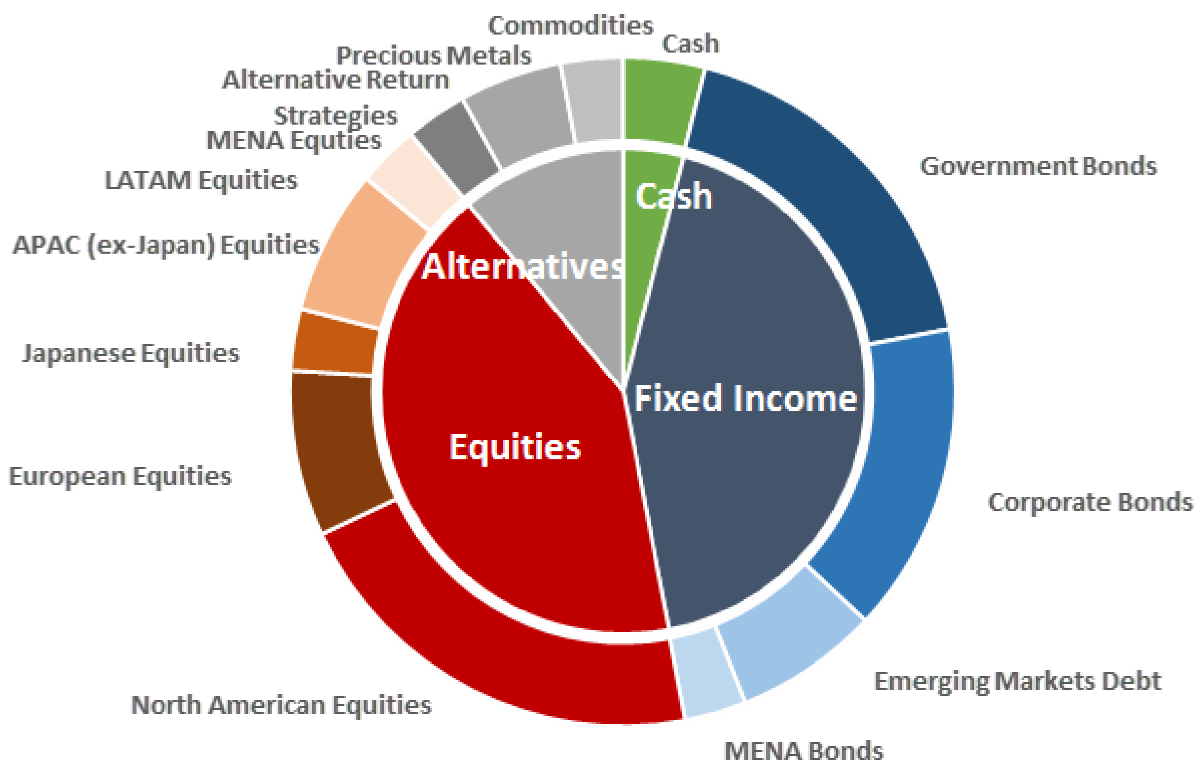
Current Tactical Asset Allocation



Asset Class	Positioning	Detail
Cash	Neutral	After allocating more cash to investment grade corporate debt
Fixed Income	Overweight	Moving to slightly overweight after adding overweight to EM dollar debt and corporate investment grade bonds
Equities	Overweight	Rotating US exposure to defensive stocks
Alternatives	Underweight	However, overweight on precious metals specifically

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