Improving global growth offsets rising US political noise

Broad-based EM recovery points to longer-lasting cycle

Risk markets vulnerable to pullbacks

Fed and ECB remain cautious about policy tightening

We see US high yield well supported in spite of high valuations

A combination of rising US political uncertainty, terror attacks in Europe and doubts on continued double-digit earnings growth weighed on investor sentiment. US treasury yields were range bound, with declining North Korea-related geopolitical risks counterbalanced by dovish Fed minutes.

Solid global growth tempers concerns about US political noise

US political noise has grown increasingly louder, with President Trump dismantling two business advisory councils on defecting CEOs and rumors, though later denied, of economic advisor Gary Cohn leaving the administration. We think that political worries should not translate into market worries for two reasons. A modest tax reform should still be expected in 2018, predicated on the willingness of Republicans to go into the US midterm elections with some accomplishments on their political agenda.

Shorter term, President Trump’s missteps are offset by further improvements in global growth, running at the highest rate since 2010 in Q2 and still strong in the current quarter according to the forward-looking data so far released.

A period of disappointing US data may be followed by positive economic surprises. US retail sales were above expectations for the month of July, with previous figures revised upwards. Also, the latest US jobless claims reports recorded some of the lowest readings of the current recovery. Globally, retail and corporate spending were strong across many countries, as evidenced by the flurry of GDP reports released for Q2. In particular, Europe continued to grow apace, while Japan surprised to the upside. Overall, although the business cycle is quite advanced in the developed market economies, it is not showing evident signs of deterioration.

President Trump’s agenda in question

Although the old adage ‘sell in May and go away’ has so far failed to hold good this year, markets may well catch up by September, which on average has been the worst performing month for equities since 1950, according to Haver analytics and Citi Research. Globally disruptive news is building up, however our broader outlook remains constructive being predicated on strong global growth and underlying earnings trends.

US equities fell last week as events in Washington created further doubts on the Trump administration’s agenda. The S&P 500 ended the week down -0.6%.

The so called ‘Trump trade’ related to the US President’s pro-growth measures is definitely over.

Concerns were heightened by the exodus of top officials from business and strategic advisory councils, with the pro-business mindset associated with President Trump being put into question.

Investors are still looking ahead to some form of corporate tax cuts in 2018. Although the equity market has stayed fairly resilient in the face of the political backdrop and the recent Charlottesville protests, continuing abandonment of the President by both business and political leaders is a cause for worry. Corporate earnings are a major pillar supporting equities, yet an unorthodox presidential leadership could continue to create volatility in the near term in US markets.

Temporary Chinese slowdown won’t derail EM growth story

A notable exception to the constructive macro picture was represented by the latest Chinese data, with industrial production contracting sharply, and retail sales and fixed asset investments weaker than forecast, following firm releases in June. Although this
might throw doubts on the outlook for EM assets, we continue to hold the view that there are good reasons to continue to be overweight EM equities and debt. The slowdown in China is a welcome occurrence engineered by the central authorities to avoid excesses in the ‘old economy’, with policymakers currently signaling that no further tightening is required. Hence, the base case remains for a benign soft landing in Chinese activity, expected in the second half of this year. In a longer term perspective, the breadth of the EM recovery, in terms of number of countries participating and levels of growth rates of those countries, is suggestive of a long and sustainable EM expansion cycle. Historically, EM recoveries have been longer-drawn-out the more widespread they were across countries.

**European equities saw renewed inflows**
European equities were up for the week, though the terror attacks in Spain eventually sparked a sell-off. Fading euro strength is to some extent allaying investor concerns about the negative impact of the currency on Eurozone corporate earnings. Equities saw outflows from the US and inflows into global, Europe and Asia ETF’s. The performance of the airline sector was affected by the recent disruptions, while gold producers rallied as investors added to safe haven assets. We would maintain a balance of cyclical and defensive sectors to better navigate temporary rough waters.

**GCC markets regained their lustre**
The GCC markets have been immune to global events and we can feel some positive momentum building up in the banking and consumer sectors in the KSA. Savola and Extra have posted gains in August of c. 10%. KSA banks too have been on the upswing with 4% to 5% gains in August. Oil trading above $50/bbl is aiding sentiment. Dubai’s large local developer posted strong results and last week we saw a pick-up in the better-quality real estate stocks in the UAE.

**Technically risk markets look vulnerable to pullbacks**
Although we continue to see the bigger picture as constructive, technically risk markets are entering a time-window marked by lower seasonal returns - August and September statistically have frequently witnessed bouts of volatility. Market breadth, a measure of the degree of participation in a rally, is deteriorating for the S&P500 and the ratio of cyclical to defensive stocks is no longer making new highs, pointing to a market possibly treading water in the shorter term. Partial profit taking may be an option, which would allow investors to keep some powder dry in case of pullbacks.

**Fed and ECB remain cautious about policy tightening**
The Fed and the ECB-July minutes were read as dovish by investors. Fed officials turned more concerned about the outlook for softer inflation, with the FOMC split between members advocating for caution before proceeding with more tightening and the ones laying more emphasis on the risks of keeping policy rates low for too long. This lack of consensus further reduces the likelihood of a rate hike by the year-end, hence the probability of durable rebounds of the US dollar.

**Disruptors in the Market Place**

Expectations of a shallow tightening cycle will preserve conditions for flows into high-yielding assets to continue.

The ECB acknowledged that the outlook for the European economy has improved, with the view that inflation, although subdued, will eventually return to target. At the same time ECB members struck a note of caution on excessive currency appreciation, hence on the potential for too much tightening denting the recovery underway. This suggests the Central Bank will proceed with caution on any measures impacting market liquidity and retain a market-friendly bias.

The Department of the Treasury released the June Treasury International Capital (TIC) report
The data show foreign investors were net buyers of US corporate bonds, although inflows slowed down materially to $2.8bn versus $26.1bn in May (the highest monthly inflow since December 2008). Across regions, June saw European investors contribute $3.7bn of net purchases, while Asia-domiciled investors were net sellers of $1.7bn worth of bonds. We remain constructive on corporate investment grade bonds as valuations look fair versus high-yielding securities.

**Strong technical support for US-high yield, but mind the valuations**
According to Moody’s investor services, as of the end of July, the trailing 12-month issuer-weighted HY default rate in the US fell further to 3.65% from a peak of 5.8% back in January. US high-yield risk premium has appeared to hold up well in spite of the recent episodes of rising market volatility. Investors are merely compensated with 380bp of risk premium today, compared to 500bp earlier this year. Moreover, the recent bond issue by Tesla due 2025 slipped below the issue price of par almost immediately, trading as low as 97.4 cents on the dollar on Friday. The Tesla eight-year securities had been priced a week ago at a record-low yield for bonds of similar rating and maturity.

**Chinese authorities crack down on debt-driven overseas corporate buying spree**
Beijing has stepped up its efforts in recent months to restrict some of the more acquisitive Chinese companies from buying foreign assets, worried that a series of purchases by China’s conglomerates around the world had been driven by excessive borrowing. The Chinese banking regulatory commission (CBRC) has asked banks to review all loans given to such companies in order to assess bank exposures. In the latest move, a statement published by China’s cabinet, the State Council, said the authorities would punish companies for violating foreign investment rules and establish a blacklist of businesses that did so.

**Ecommerce rules**
The shift to ecommerce continues in the US retail sector, with the major athletic retailers mostly affected. Footlocker’s shares fell 28% on Friday on a poor sales outlook and Underarmour shares are already down 60% over a year. In a hyper-competitive environment accessibility to athleisure products, price and delivery are key to revenue growth. Nike recently agreed to retail on Amazon to ensure visibility. Amazon controls 30% of the US ecommerce markets. While President Trump’s tweet on Amazon causing “great damage to
tax-paying retailers,” triggered a drop on the day of 1.8% in Amazon’s shares, the stock is still up 27% over a year. Amazon’s possible foray into healthcare is the latest in its growth strategy, whether it is Alexa calling a doctor for you or home delivery of your prescription medicines.

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