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Smart[im]: Weekly Market Review

18 May 2018
Smart Investment Management

The week to date as at 12 p.m. Friday (GMT).

Markets and Key Events

Rising US interest rate expectations leads to a mixed week in markets

It was a mixed week for markets as expectations rose for a more hawkish United States Federal Reserve after robust retail sales data was released for April. The US dollar resumed its recent upward trend versus a basket of internationally traded currencies. US government Treasury bonds sold off, with the 10-year yield hitting an intraday peak on Friday of 3.128%, its highest level since July 2011 (yields move inversely to price).

Emerging markets under pressure, whilst European and Japanese markets benefit

Emerging markets came under pressure from the rising US dollar, with the MSCI Emerging Markets index falling 1.8% over the week (up to Friday, 12pm London time), as countries reliant on international funding saw their debt servicing costs increase. The US Standard & Poor's 500 Index fell 0.3% with those sectors perceived to be bond proxies: utilities, telecoms and property; the worst hit sectors. The EuroStoxx 600 index and the UK's FTSE All Share both benefitted from currency weakness, rising 0.6% and 0.7% respectively over the week, as those companies deriving a significant proportion of their revenues from overseas become more competitive, generating higher profits, as their revenues are translated back into a weaker Euro or Sterling. Similarly, the Japanese Topix index rose 1.1% as the Japanese Yen weakened against most other major currencies.

Chinese 'A' shares manage to shine

Despite most emerging market equity markets falling over the week, the Chinese Shanghai Composite index rose 1.0%, helped by President Trump reversing sanctions on ZTE Corp, a Chinese telecoms group, which fell foul of US authorities for having sold equipment to Iran and North Korea.

Australian equities dragged down by Materials, despite strength in Energy

The Australian S&P/ASX 200 index is down marginally by 0.5%, ending a six-week run of gains. The energy sector led the market this week as oil prices continued to rise; the S&P/ASX 200 Energy index gained approximately 2% over the period. However, this positive contribution was offset by Friday, after weakness in the Financials, Materials and Telecom sectors. In economic news, on Thursday, the April employment figures were released, with the economy adding 22,600 jobs, ahead of analysts' expectations of 20,000. The positive news led the Australian dollar higher at USD $0.7543 however, by the end of the week the Aussie dollar finished trading at USD $0.7518.

Gold hurt by rising interest rate expectations

Gold fell over the week, now trading at $1,286, its lowest level since late December 2017, hurt by rising expectations for US interest rates. Gold tends to perform well as a store of value either during times of market turbulence, or as a hedge against inflation if real yields (interest rates less inflation) are expected to stay negative. When expectations are rising for US interest rates, gold generally suffers.

Brent crude oil breaks through $80 a barrel

Brent crude oil climbed to over $80 a barrel on Thursday, with expectations growing for supply cuts from both Iran and Venezuela. Iran's supply is expected to fall as a result of the US announcement to reimpose sanctions, whilst Venezuela is suffering from a collapse in crude oil exports. The national Venezuelan oil company, PDVSA, is battling with default over unpaid bonds, with creditors threatening to seize overseas assets. Some commentators are suggesting that should Iranian and Venezuelan oil supply fall in tandem, this could provide the perfect environment for oil to return to $100 a barrel. Brent crude is currently trading at $79.6, whilst US WTI (West Texas Intermediate) is trading at $71.6 a barrel.

Portfolio changes

Equity exposure on Smartfund Growth was reduced this week following a combination of markets having recovered most of the losses experienced in February, and the volatility overlay leveraging up exposure as volatility has fallen away in equity markets. The exception to this was energy, where we maintained exposure whilst the sector is benefitting from a resurgent oil price. The US CBOE Vix Index (Chicago Board Options Exchange) is now trading at just over 13, having spiked above 50 in February.

Issues under discussion

US 10-year Treasury yields have decisively broken above 3% this week, for the first time since 2011, having traded as low as 1.36% in the middle of 2016. This is all the more significant as US government bonds, which are AAA rated, are trading with a positive real yield, i.e. interest less inflation. In recent years, we have been consistently underweight fixed income, is now the time to change?

US government bonds trade at a materially higher yield than either UK Gilts or German bunds, with the 10-year Gilt yield trading at 1.54% and the 10-year Bund yield trading at 0.63%, both providing a negative real yield once inflation is considered. However, as a Sterling denominated fund, it would be normal to hedge out currency risk when investing in a safe asset, such as US Treasuries. Due to the interest rate differentials between the US and the UK, the cost of hedging out US dollar risk is currently about 1.5%, making US Treasuries much less attractive and also earning a yield beneath the rate of inflation.

Secondly, whilst government bonds might provide diversification against the shock of lower growth, should the world economy experience the shock of higher than anticipated inflation, government bonds would be expected to sell off, as expectations rise for higher interest rates. In this environment equities would be expected to sell off as well, compounding the pain.

Therefore, despite the materially higher yields available on US Treasuries, we are not tempted to add to them as a diversifier of risk, preferring to hold cash at this point in the cycle.