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Smart[im]: Weekly Market Review

26 January 2018
Smart Investment Management

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

Markets and key events

Currency effects dominate markets

Currency played an important role in returns this week, as the US dollar's slide, which began in January 2017, accelerated following a comment from US Treasury Secretary, Steven Mnuchin, being taken out of context. The US dollar index fell to its lowest level for three years, having briefly gone through $1.25 versus the Euro and $1.43 versus Sterling. The fall was only halted following a supportive statement in favour of a strong dollar from President Trump.

Weak dollar favours US and EM, whilst Eurozone, UK and Japan disappoint

US equities rose over the week, with the Standard & Poor's (S&P) 500 index and technology dependent Nasdaq index both rising 1.0%. Both benefitted from a temporary deal having been struck between the Democrats and Republicans to reopen government after a shutdown that lasted for less than three days due to a lack of funding. The European EuroStoxx 50 on the other hand, slipped 0.1% over the week, despite January's composite purchasing managers index, a much-respected lead indicator, having risen to a 12-year high. The rapid ascent of the Euro versus the dollar was largely to blame for the weakness. It was a similar story for UK equities as the FTSE All Share fell 0.9% over the week as Sterling climbed to levels versus the dollar not seen since before the EU referendum. The MSCI Emerging Markets index received a boost from Latin America, which played catch up over the week, after a court dismissed an appeal by former President Lula da Silva for his corruption conviction, dealing a blow to his hopes of making an election comeback later this year. This helped to alleviate investor concerns as to the success of populist parties in Latin America during a year with an unusually high election count.

US dollar decline accelerates, protectionism on the rise

Steven Mnuchin was widely quoted from the World Economic Forum in Davos this week for saying "Obviously, a weaker dollar is good for us as it relates to trade and opportunities". However, his second sentence was largely ignored "Longer term, the strength of the dollar is a reflection of the strength of the US economy and that it is, and will continue to be, the primary reserve currency." Currency traders took his statement as a green light to sell the US dollar, which fell into freefall until President Trump the following day was quoted on CNBC "The dollar is going to get stronger and stronger and ultimately I want to see a strong dollar". This was in a week that President Trump announced protectionist measures, introducing tariffs of up to 30% on imported solar cells and 50% on imported washing machines. Investors will be watching closely to see whether these protectionist measures continue in a narrow band, or widen out, perhaps to include intellectual property rights at which point China can be expected to retaliate.

ECB interest rates on hold and few clues as to the future of European monetary policy

The European Central Bank (ECB) left interest rates on hold this week and left few clues as the future of its quantitative easing programme, despite the increasingly robust picture for the Eurozone economy. Mario Draghi, president of the ECB, reconfirmed the commitment to its €30bn a month asset purchase scheme until September or "beyond if necessary". Despite the continued dovish tone, 10-year German bund yields rose over the week, briefly touching 0.64%, before settling back at 0.62%, their highest level since December 2015. Elsewhere, the Social Democratic Party of Germany agreed in favour of another grand coalition, clearing the way for the formation of a government post the September 2017 election.

Sterling – US dollar weakness, rather than Sterling strength

Sterling rebounded to levels versus the US dollar not seen since before the UK's referendum on EU membership, as Chancellor Philip Hammond was quoted at Davos favouring a soft as possible Brexit, before subsequently being rebuked by Prime Minister Theresa May. However, in truth, this leap higher for sterling has more to do with dollar weakness than sterling strength. Versus the Euro, sterling is trading at €1.15, versus $1.25 or higher pre-the referendum.

Latin America plays catch up

The sharp fall in the US dollar continued to favour Asia and the emerging markets. Latin America had an added boost this week from the failure of former President Lula da Silva to overturn his corruption conviction, a major hurdle to his attempt at getting re-elected in the October Brazilian general election. In a year when there are also elections in Mexico, Colombia, Costa Rica, Venezuela and Paraguay, this gave hope to investors that populist parties will not have it all their own way. The MSCI Latin America index rose 4.2% over the week.

Continued rise of the oil price

Brent crude oil briefly passed through $71 this week, the first time in over 3 years. The gold price also continued its recent rally, climbing to $1,358, its highest level since mid-2016.

Strengthening lead indicators pushes Australian market higher

The Australian S&P/ASX 200 rose 0.74% over the week as stocks were pushed higher again amid ongoing optimism for economic growth domestically and globally. Most notable this week were the stronger domestic signals from the Westpac-Melbourne Institute Leading Index, with readings above 0% indicating an increase in future economic activity. The index jumped from +0.66% in November to +1.41% in December.

Changes to the portfolios

With Sterling having risen to levels not seen since before the UK's referendum on EU membership, we have taken the opportunity to remove the partial US dollar hedge that we have held on the portfolios since January 2017. Currencies are notoriously hard to call, and we are not making a statement regarding the future direction of the US dollar, which could conceivably continue to weaken, despite rising interest rates. However, as risks to Sterling remain over Brexit negotiations, and one of the key risks that we consider is an appreciating dollar due to unexpected US interest rate rises, on balance we have felt it right to remove the hedge.

Issues under discussion

Whilst broadly being constructive on markets this year against a back ground of continued synchronised global growth, we continue to consider the risks that investors face.

The principle risk that we contemplate is the re-emergence of inflation requiring central banks to raise interest rates faster and higher than they are currently indicating. However, there are a number of other risks that could provide stumbling blocks for investors this year. These include the rise of protectionist policies, with President Trump expected to introduce further measures in the run up to the US mid-term elections. The oil price continuing to strengthen is another risk. Investors having previously been conditioned to oil trading at $100, have now become conditioned to lower priced oil due to the rise of US shale oil. However, if this optimism for a low oil price is misplaced, an oil price much above $80 a barrel would start to act as a brake on global growth. Also, rising political risks, following a relatively benign year in 2017. There is plenty of scope for a political upset in both the Emerging Markets or Europe this year. And finally, outside of geopolitical risks such as North Korea, a risk that is not often commentated on, the risk of a melt up. Markets typically over extend to both the downside and the upside, and although asset prices are high, they are nowhere near the levels achieved in say, the dotcom bubble. Rising global growth against a backdrop of continued subdued inflation could sow the seeds for a market melt up, rather than the recession risk that most commentators are focused on.