The U.S. - Going for Gold again

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- **All three major US indices break records on Thursday**
- **Disappointing retail data follows to spook markets**
- **E-commerce's exponential rise continues**
- **KSA eases QFI rules to encourage foreign inflows**
- **Oil rallies on hopes market closer to rebalancing point**

It's a marked reversal from February this year when markets fell sharply on fears of a global recession. **All three major U.S. stock indices reached new records on Thursday.** The Dow Jones Industrial closed at 18613, the S&P 500 at 2185 and the Nasdaq at 5228. The tech-oriented Nasdaq was the only index to continue its gains into Friday.

Developed market sovereign bond yields also joined in, reaching record low yields. In the UK both Gilts and corporate investment grade bonds saw further yield compression, with Gilts recording all-time low yields.

Disappointing retail sales data spooked markets on Friday. Retail sales were unchanged in July, with producer prices falling by the most in 10 months and consumer sentiment climbing less than economists had forecast. **Consumer spending has been the main driver of economic growth in recent quarters**. Following the data, federal funds futures on Friday indicated a 42% chance of a rate rise this year, down from 48% on Thursday. The FOMC's assessment of the macroeconomic outlook, alongside their forward projections on the dot plots suggest that a slow pace of rate increases should be expected in the US. However, monetary policy divergence between the Fed and other major central banks, as well as the global search for yield, will continue to bring in strong technical support for US government yields. Sub-zero bond yields are causing concerns amongst bond investors, even as they add to positions tactically on the expectation that rates will move further into negative territory as central banks from the BOE to the ECB embark on new bouts of asset purchases. Currently, all developed market ten-year real yields are negative, while the outstanding value of total bonds with negative yields runs above $12Tn.

The **LIBOR has been edging higher across the curve versus other short-term rates,** on the back of money market fund reforms due in October this year. These soon-to-be-enforced regulations are pushing fund investors out of short-term corporate debt instruments (such as corporate commercial paper, promissory notes, etc.), into purchasing short-dated government-related funds. As a short-term positive, investors positioned into floating rate bonds referenced to LIBOR should enjoy higher coupon payouts.

The last time all three US indices reached a record together was on 31st December 1999, when they subsequently went on a downhill spiral on overly stretched valuations. After the end of the dot.com boom and the financial crisis, it has taken the Nasdaq 16 years to reach a new historical high. The Dow and S&P 500 recovered quicker and have been notching new records over the past two years.

There are concerns that equities may now have entered bubble territory as record-low interest rates are enticing investors to take on ever more risk.

With government-bond yields hitting record lows, equities still seem to offer good value in relative terms, although investors are forgetting that lower yields ultimately portend a poorer macroeconomic outlook. The dividend yield on the S&P 500 at 2% is well above the yield on the 10-year Treasury note at 1.5%. **Yet, the volatility and risk premia associated with equity investments still see bonds as better performing in 2016.**

In spite of years of central banks' easy monetary policy that has pushed buyers into risk assets and driven a major equity bull market, the macroeconomic outlook hasn't lived up to expectations. We doubt strongly that the potential for more upside lies in further liquidity injections, rather than in concerted efforts by monetary and fiscal authorities to shock investors with measures appropriate to kick start the economy onto a new growth path.

This is the eighth year into a bull market for global equities. As they are not cheap as compared with their ten-year average price to earnings multiple, we hold the view that investors should maintain a strong bias towards stock and sector selection, affording capital preferably to companies which offer growth at reasonable value and an above-market dividend yield.

Although the tech-laden Nasdaq Index is trading at 24X trailing earnings, its 10-year average being 20X, in a sluggish environment **where investors are willing to pay a premium for growth such valuations do not come across as frothy yet.**

In 2015 the rise of the US indices was propelled by information-technology stocks, in particular the so-called "FANG's" (Facebook, Amazon, Netflix and Google) and barring Netflix their rise continues this year. Whilst retail outlets are closing down ecommerce is booming, with stellar earnings and revenue growth providing a backbone to the ascendancy of the internet giants. However, one cannot paint all ecommerce ventures with the same brush; whilst Amazon and Alibaba are commanding a large share of online sales globally, the smaller players must apply discount policies to gain market share, which dent into their profits. **Scale of operations and logistical efficiency will decide the new winners in a tight-margin environment.** With a large part of the emerging country markets still untapped, the outlook for growth in ecommerce remains bright.

The earnings season is drawing to an end with yet another quarter of falling earnings, stocks hitting record-highs notwithstanding. Analysts are cutting their forecasts following the latest reporting season and now expect S&P500 earnings to fall 0.8% in the third quarter and 0.1% for the full year, according to Bloomberg data. Banks earnings will probably drop 8.7% this year. **The only industry immune to the recent downgrades is technology.**

The European indices have recovered their post-Brexit drop on mixed economic releases. The German economy grew a better-than-expected 0.4% last quarter, buoyed by export demand. The strong performance helps the recovery in the eurozone, even as some peripheral countries continue to lag behind. Euro-area GDP rose 0.3% in the period, although Italy remains a laggard with flat growth disappointing markets looking to 0.2% growth.

The Japanese carry trade is taking on a whole new meaning for equity investors. **Japanese equities are yielding more than US equities**. The yield on the Topix stock index has overtaken that of the S&P 500 at 2.31 percent. "Quality income" investing — the conservative strategy of buying companies with strong balance sheets and consistent profits that reliably pay an income — is working well in Japan and beating the main Japanese index. We hold the view that it is worth looking into Japanese stocks for income opportunities. The government is continuing to take a more active role with growing holdings of ETF's through its pension fund. Cash payouts are increasing, with stock buy backs already reaching last year's totals. Dividends per share are estimated to rise 7.5% over the next year.

Valuations in Japan are low versus history as the Nikkei sank into a bear market in January and investor sentiment remains negative. Heavyweights in the Japanese benchmark are dominated by exporters, hence the yen and the Japanese stock market tend to be inversely correlated. **A weaker yen brings an outlook for improved earnings, boosting stock returns.** In September the BOJ is expected to announce new measures aimed at staving off deflation and weakening the currency. A rate rise in the US by the year end should compound the negative effect on the Japanese currency.

The Chinese mainland equity indices are positive this quarter (but -13.8% YTD) and still lagging behind the Hangseng Index (+3.9% YTD). In China the July economic numbers were slightly weaker than expected with Industrial production +6% YoY and retail sales growing 10.2%. **Emerging markets continue to see inflows helped by relatively cheaper valuations and accommodative monetary conditions worldwide. Investors should be overweight EM equities, as the economic cycle in the emerging countries continues to improve and remains out of lockstep with the DM cycle.**

Oil prices have recorded their best week since April and the S&P500 energy sector had its best week in a month as OPEC announced that it would hold an informal meeting in September and Saudi Arabia's energy minister said that the kingdom could participate in coordinated action to help rebalance the oil market.

The Saudi Tadawul announced last week modified regulations for Qualified Foreign Investors (QFIs). Key changes include the cutting of the minimum AUM requirement to USD1bn (USD5bn currently). Sovereign wealth funds and university endowments will be allowed to invest under the new rules. Foreign Ownership Limit will increase. However, we do not expect any substantial foreign inflows until settlement rules move from the current T+0 cycle. **KSA inclusion in MSCI and FTSE EM benchmarks is expected in 2018 at the earliest.**

The Saudi Index is -24% over a year and -5% in 2016 and is lagging both the global markets and GCC peers. The Index is trading at 14.9X trailing price to earnings, a premium to emerging markets. Privatisation of state assets with the resultant broadening of the investable market will increase interest from foreign investors. **Whilst overall earnings have fallen 11% this quarter Tadawul-listed healthcare firms have grown their bottom-line by 4% year-on-year.**

The Qatar (DSM) Index has rallied 10.5% quarter-to-date as better than expected earnings from Qatar National Bank and Ooredoo (telecom) have reignited interest in Qatari equities. Qatari stocks constitute c.1% of the MSCI Emerging market Index. Although the DSM Index is trading at a trailing price to earnings ratio of 15X (higher than the GCC and EM), the high dividend payout (3.7% for the index and even higher for some of the banks) will not lose its appeal with investors.

The world is going gray, as the places where the old outnumber the young are steadily on the rise. Joseph Chamie, who spent 25 years studying population patterns at the UN, says that by 2075 seniors will outnumber juniors globally. **With growing expenditure on healthcare a primary focus globally, the recent weakness in the sector seems to offer a good opportunity to invest in healthcare stocks.**

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