Sanctum Wealth Management

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November 18th, 2019

Don't Give Up on a Fed Rate Cut

- **Fed rate cut back on the cards?**
- **US economic data weakens – poor Q4 growth in prospect**
- **UK equities primed for outperformance**
- **Signs of eurozone financial sector reform**
- **Foreign investors keep the faith in Indian assets**

It was almost inevitable that when the markets had moved to discount virtually no Fed rate cuts in the coming twelve months that economic data would suggest otherwise. A week of poor US economic data had the US bond market rallying and economists questioning whether indeed a rate cut might be on the cards again. At this stage the market prices just a 33% chance of a rate cut at next March's Fed meeting. They may have to think again.

Last week's US economic data surprised to the downside. Signs are that consumer spending and the labour market may be weakening. The Atlanta Fed's GDP Now and the New York Fed's GDP Nowcast estimate of fourth-quarter GDP growth based on the flow of economic data fell to a

range of 0.3% to 0.4%.

Industrial production fell 0.8% month-on-month in October the third decline in four months. Retail sales rose just 0.1% in October, excluding volatile items such as auto sales. The retail data was no disaster but weaker than expected. Underlying trends appear weak; some measures of consumer confidence have softened in recent weeks, and initial jobless claims have risen.

US inflation remains relatively well behaved. There have been worries in recent months that a pick-up in US inflation could stymie the ability of the Fed to ease policy if there were more meaningful signs of a slowdown. However, in the event, the latest US inflation news was relatively benign. Core inflation at 1.7% is below the Fed's 2.0% target and the rental inflation number a key figure in the calculation down to the weakest reading on some years.

The equity markets continue to believe we are in a goldilocks environment where any disappointments in growth will be met with further easing of policy by the central bank. We can't disagree. The Fed Chair Powell in his testimony to Congress last week reiterated the Fed statement from the last meeting that the monetary policy remains data dependent.

The leadership of the global equity market rally has switched to Eurozone and Japanese equities in the past few months. Investors are taking the bet that policymakers in both areas will be supportive of their economies as we turn the year. However, given the double-digit returns from both markets in the past three months, investors may be looking elsewhere for action - stand up the UK market.

Has the UK equity market's time finally come? UK equities are the marked underperformer in the year-to-date. UK equities are up only 8.5% against Europe ex UK and the US up 23.7% and 24.5% respectively. Of course, investors would prefer the certainty of knowing the election outcome before jumping in. At this stage, we would sense that the momentum is with the Conservative party. Commentators are increasingly confident they will achieve a majority in Parliament. However, two other outcomes fill investors with horror. The first would be that there is no overall winner and various complexions of coalitions cause havoc. Another would be a win for the Labour party or a Labour- led coalition that then sets on a path of left-wing 'reforms' to the economy and leaving a decision on Brexit to the vagaries of further negotiation and a likely second referendum.

We prefer to be optimistic, and indeed the balance of odds is that the UK electorate will vote in a Conservative government with a majority sufficient for them to initially complete Brexit. Beyond Brexit, there is likely to be a significant easing of fiscal policy. In our view, investors should focus on domestic plays probably through small/mid- cap indices such as the FTSE250. We expect returns from the equity market to be enhanced for foreign investors by a further rally in sterling against the dollar.
Euro area equities have been a stellar performer over the past three months. There are signs that the rather short- term outperformance could be supported by the creep of **reform in the eurozone, particularly in the banking sector**. There is still to this day a struggle to construct an integrated, fully functional banking union in the eurozone; one that has a single supervisor (the ECB) and a single, consistent resolution framework for failing banks of whatever size. For seven

years, there has been huge resistance from Germany and the northern 'creditor' states to one key element – a single deposit insurance scheme across the union. They saw it as a covert form of transfer union that would leave well-supervised German savers and its taxpayers on the hook for ill-disciplined and delinquent southern lenders.

However, it does look as if Germany may be finally prepared to concede some ground. In recent weeks, Olav Scholz, Germany's finance minister, suggested in a paper (and in an FT op-ed article) that he might back a form of deposit re- insurance scheme that would be a backstop for the region-wide €100,000 deposit guarantee. This is potentially a significant shift just as a new EU administration is about to be installed. A single guarantee scheme would ease liquidity pressure on national banks during a flight from a particular sovereign's debt as well as reducing the risk of an intensifying credit crunch like we saw in Greece. It could, in some respects, justify a higher price to book ratio for smaller peripheral regional banks.

Domestic sentiment in the Indian economy is weak. Indian current affairs programs characterise the situation as a crisis. Could it really be that bad? For sure, the economic data is poor. Industrial production fell 3.7% in the third quarter, and the monetary system appears to have frozen over. The formal banking system has not been able to compensate for the marked deterioration of the shadow banking industry. Cuts in interest rates have had limited impact thus far because even if a company wanted to take advantage of the lower rates, you would struggle to find a willing lender.

This is certainly not the greatest crisis the Indian economy has faced, and one suspects it will just take time for things to be righted. However, it will take the significant intervention of the government to make things better. The BJP government has been reform-minded from the start. Yet, the pace of government reform has to follow the political cycle. As much as the Modi government may want to push ahead with reforms, they also realise that they have to stay on the right side of the electorate. The BJP and partners still must build a sufficient majority in the upper house to push ahead with more reforms. In the meantime, the central bank will be under pressure to provide further support for the economy. Despite the recent rise in inflation, some economists are hopeful for an additional rate cut before year-end.

Despite the near-term economic challenges, we still see good long-term interest from foreign investors to gain access to the financial markets. Indeed, against the problematic market backdrop, foreign investors have been buyers of Indian assets over recent months. They have used the markets absolute and relative weakness as a buying opportunity. Foreign portfolio investors invested a net ₹14,435.6 crore into equities and ₹4,767.18 crore into the debt segment during November 1-15, taking the total net investment to ₹19,202.7 crore. Foreigners were net investors in both July and August too.

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