Weekly Intelligence Report

Our views on this week's investment events - FOR PROFESSIONAL INVESTORS - 17 May 2016

Overview

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Last week was a relatively quiet one for global financial markets, with few significant market changes and little in the way of new information, either in terms of macroeconomic data or on the policy making fronts. Times such as these are ideal for taking stock, revisiting old themes and starting to explore new ones.

In the first of our articles, we revisit trends in oil prices, and in commodity prices more generally. Although there has been a notable rebound in prices since February, we would not characterise the rebound as "healthy". Christoph von Scheurl reviews recent oil market developments, and casts a sceptical glance at the fundamental underpinnings for the recent recovery.

In a new departure for this publication, which has often focused on global, or emerging markets themes, Richard Barwell turns a spotlight on events closer to home, examining tentative, but convincing evidence that the UK economy is unexpectedly slowing both in absolute growth terms, and relative to many of its trading partners, and posits some potential explanations for this phenomenon.

Lastly, Daniel Morris returns to the age-old question of the link between the electoral and the market cycle, a timely issue given the approaching presidential elections in the US. In sifting through post-election market performances over the past sixty years or more, he comes to the nuanced conclusions that the composition of Congress matters more, both for overall market direction and for relative sector performance, than the party to which the incoming president belongs.

Three different themes, three different perspectives which we hope you find informative and thought-provoking.

$50 oil? Time for a reality check

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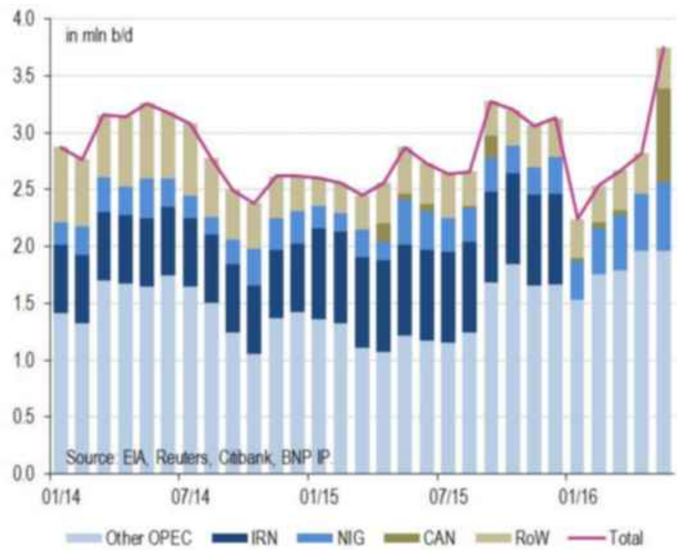
Back in January, oil prices undershot their fundamental values and reached sub USD $30. Markets have corrected a long way since, and they now appear to be moving towards the other end of the price spectrum.

We see evidence that supply has started to normalise in the data that non-OPEC production has turned. Declines are now broader based in the US, and also in non-OPEC-ex US areas. Despite this, the underlying supply picture remains challenged by an ever increasing OPEC output which has absorbed year-over-year, twice the declines seen in US oil production (April '15 -April '16: OPEC c.+1.7 million BPD vs. US c.+0.8 million BPD - see chart below).

Estimated historical unplanned liquied fuels production outages



Source: EIA up to April, figures for May carried over with exception for Nigeria and Iran that rely on external resources.

The overall oil supply situation has improved, but from our perspective, it seems that the underlying fundamental market balance – in absence of temporary disruptions – has not yet been restored. That is, short term disruptions versus longer-term (ongoing) improvements.

As we have previously commented, markets should not be paying for adding production capacity when none are yet needed. As a consequence, and in absence of temporary supply disruptions, market prices should be anchored at a assumed production cash costs of US shale oil production (c. 35-45 USD per barrel). We also acknowledge that the supply situation has and will continue to improve and thus believe that skew to price downside below production costs has declined.

In retrospect, the strong price increases experienced since March have been particularly linked to two factors: a broader 'reflation' macro theme that underpinned global asset prices, and OPEC/Russia 'talking up' oil prices by indicating their plans to limit output.

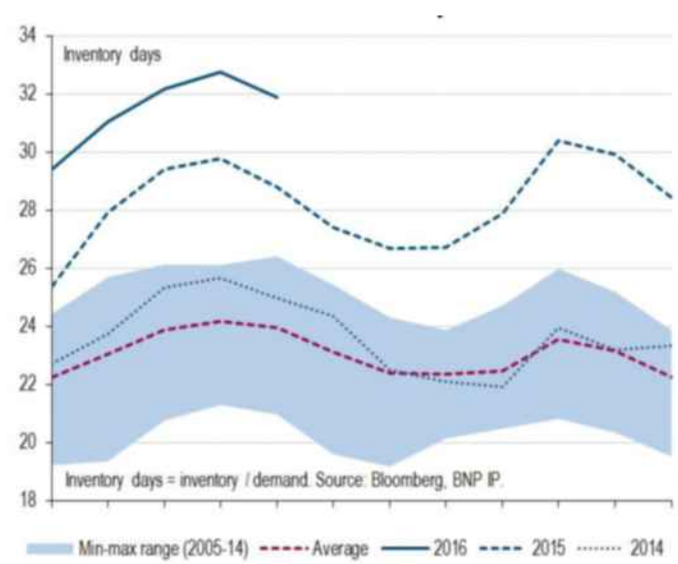
On the latter – as discussed in the March 25 issue - we did not see a tangible risk materialising from the threat of a potential OPEC output freeze. However, this 'fundamental void' created by OPEC's rhetorics has now been filled by unusually large supply disruptions: since January, unplanned supply disruptions increased by about +1.5 million BPD with the majority of disruptions occurring in May through the fires in Canada (c. +0.8 million BPD lost production in May).

Simply based on arithmetics, the increase in disruptions should have pushed the physical demand/supply balance into a temporary deficit - supporting markets over the short-term.

Additionally, markets may briefly be further supported by positive headlines, while current disruptions and a seasonal increase in demand should lead to higher inventory draws. We should also see further falling rig counts as the main impact of low prices in January should be coming through (rig counts tend to lag prices three to four months). However, headwinds to oil prices are expected to build over the coming months – which should eventually help limit or turn markets.

From a supply perspective, we anticipate disruptions to ease in the coming six to eight weeks in Canada, the North Sea and partially from Nigeria. A very large inventory overhang still exists that needs to be worked through by markets (see chart below) and a key risk is to continue upside surprises on OPEC production.

US crude oil inventory days



Source: Bloomberg, BNP Paribas Investment Partners

From a price perspective, should oil drift further above shale cash-costs, we would anticipate an increase in hedging demand and some near-term supply additions (at about $50 USD, there are roughly 200,000 BPD of drilled but unfinished well capacity that could quickly return to markets).

To further clarify, we argue here from the perspective of normalisation of temporary demand/supply effects, high inventories and hedging demand. We also think that some production will return to markets, but this is not the key driver in our view.

As opposed to some expectation, we do not anticipate a similar magnitude in the decline of oil prices as witnessed following the price rally in the first half of 2015. The underlying supply situation in the oil market has been adjusting and non-OPEC/non-US production declines have longer lead times to recover. Also, a number of factors exist that will likely lengthen the response time of shale production including problems quickly bringing back labour or financing balance sheet issues.

Finally, as previously addressed, a potential bigger short-term risk factor for oil is the length of non-specialised oil investors (i.e. macro/retail investors) in the market. Their global 'reflation' view - largely based on perception that demand will drive asset prices higher - may receive a serious kink as the recently more positive perception on China growth becomes challenged. Therefore, it is good to consider that a lion share of oil demand growth has come from emerging markets – a region on which the Multi-Asset Solutions team have a weak economic growth outlook.

In conclusion, there is potential for prices to continue trending higher in the short term. However, as headwinds start building up, prices may roll-over to realign with our fundamental view that the underlying market has not yet fully rebalanced and needs further gradual adjustments (in absence of further supply disruptions).

UK GDP in 2016: do recoveries really die of old age?

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The recovery in UK GDP appears to be running out of steam. The economy has expanded at an impressive rate since the start of 2013 - impressive that is at least relative to the anaemic pace set by her G7 peers. However, the latest data suggest that growth is slowing and in this article we discuss possible explanations.

The Bank of England's latest Inflation Report sets out the facts. Quarterly growth slowed at the turn of the year from 0.6% in Q4 to 0.4% in Q1 and Bank staff expect growth to slow further in Q2 to 0.3%. The business surveys corroborate that slippage in momentum in the official data: the PMI activity balance for the services sector fell 1.5 points to 52.3 in April, the lowest level since February 2013. Nor is the shift in tone confined to the data on activity. The Report notes that survey measures of investment intentions have eased, demand for bank credit has softened among large companies, employment growth has slowed markedly, and there has been a 'striking fall' in commercial property transactions.

One explanation for the apparent slowdown in demand is that it is an illusion. The national statisticians publish their first estimates of the level of activity in a given quarter within a matter of weeks of the end of that quarter. Over time, they receive additional information about the level of output, income and expenditure which allows them to refine those early estimates. On occasion, the profile of growth painted by the initial estimates has been revised quite substantially with time as more data has become available. In this case, the Bank of England expects the mature data to show a more measured pace of decline between the fourth quarter of 2015 and the first quarter of 2016. Bank staff highlight in particular the weakness of activity in the construction sector as one area in which revisions might occur. Nonetheless, the slowdown in demand since late 2015 does indeed appear to be the real deal.

For those of a statistical persuasion, the fact that growth has slowed in the United Kingdom may not come as a surprise. A cursory glance at the data reveals that uninterrupted periods of robust expansion do not last indefinitely. Sooner or later the expansion phase of the business cycle comes to an end. Indeed, many investors claim that the US and UK economies have been in the mature stage of a cyclical recovery for some time and are therefore 'due a recession', or at the very least a temporary pause in growth. From this perspective the slowdown in growth in the UK is not a puzzle; on the contrary it is consistent with the natural order of things.

Economists on the other hand are sceptical that recoveries die of old age. They look instead for a causal factor - a culprit - which explains the demise of the recovery, and for many commentators, central bankers are the usual suspects. In the immediate aftermath of a deep recession, central banks need to keep interest rates sufficiently loose in order to stimulate above trend growth in demand so that the spare capacity that emerged during the recession can be eliminated. Once the economy is back in balance, then the stance of policy must be normalised to ensure that demand growth slows to match the rate of expansion of the supply side. Likewise, in the opposite phase of the business cycle, central banks must tighten policy in a boom to engineer sub-trend growth to bring the economy back into balance, and that might even involve an outright contraction in output.

The small hitch with the narrative that the current recovery died of natural monetary causes is that there has been no gradual tightening of the monetary stance that has choked off above trend growth. The Bank of England has left interest rates and the size of its quantitative easing portfolio on hold, and if anything the market has been pushing back the expected timing and scale of the future hiking cycle. Moreover, the European Central Bank has effectively eased a broader measure of sterling monetary conditions through the spillover effects of its asset purchase programme.

The other place to look for explanations for a slowdown is shocks: developments at home and abroad which weigh on demand. One obvious candidate explanation for our puzzle is the anaemic state of the global economy which has made the UK recovery increasingly reliant on the resilience of domestic demand. Had income growth been more robust overseas, net trade might not have detracted from growth in the second half of 2015. The (until recent) strength of sterling is also likely a contributory factor here, weighing on the overseas demand for UK output, particularly in the manufacturing sector, and boosting demand for imports.

The recent decline in oil prices is also likely to have influenced the profile of UK GDP. On the one hand, households have enjoyed a welcome boost to disposable income which has supported consumption. On the other, the new reality of lower oil prices will have weighed on investment in the UK's extraction sector. It is hard to pin point when exactly consumers spent the oil dividend. However, the data on investment spending are more revealing: extraction investment fell by around 40% over the year to 2015 Q4 knocking three and a half percentage points off overall growth in business investment.

Finally, there is one domestic factor that has likely contributed to the slowdown in demand. The Inflation Report documents in some detail how the uncertainty generated by the upcoming referendum over the United Kingdom's membership of the European Union has weighed on the economic outlook. Bank staff note that elevated uncertainty can depress demand through a number of channels: directly via higher precautionary savings and delayed investment, but also indirectly via a tightening in financial conditions as risk premia widen.

Market party: which political party is best for the S&P 500?

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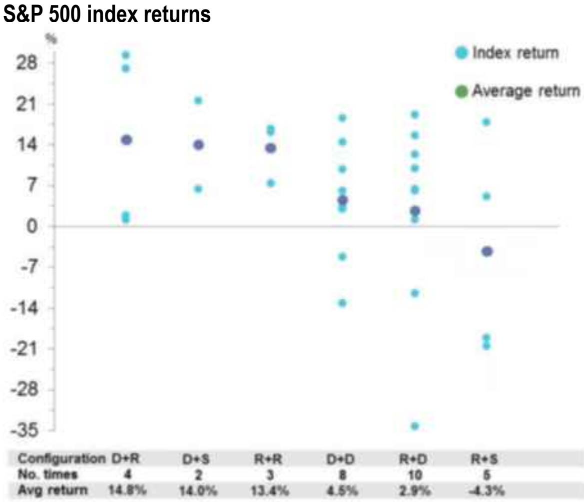
Presidential elections inevitably lend themselves to speculation about the potential impact on the US economy and financial markets. Periods of robust or weak economic growth become associated with the leader at the time, regardless of the president`s actual influence. While the U.S. President is commonly considered the “most powerful person in the world”, it is in fact the decisions of the Federal Reserve’s (Fed) president that have a more meaningful impact on the rate of economic growth. The composition of the government also has a comparatively modest effect on the economy as the U.S. government accounts for a relatively small share of the overall economy, around just 30%, compared to well over 50% in parts of Europe.

Presidents, of course, do matter, particularly when it comes to major initiatives such as the tax cuts implemented under President Ronald Reagan or the New Deal under Roosevelt. But the cooperation of Congress is as important since the president alone can implement relatively little. Consequently, it is more illustrative to look at not simply the returns on the stock market under different political parties, but the combination of the president’s and those of Congress. Policies devised when one party controls both branches of the government are likely to be very different than when compromise is necessary.

Since 1952, there have been 32 sessions of Congress under various presidents. The combination that has corresponded with the highest average return for the S&P 500 has been a Democratic president with a Republican Congress, with a 14.8% return on average, followed by a Democratic president and a split Congress, where no single party controlled both houses. Under this configuration, the average return was 14.0%. The combination with the lowest returns was a Republican president and a split Congress, averaging -4.3% (see figure). Of course these results should not be seen as having too much predictive value as there are far too few examples of each to be statistically significant. The top scoring combination has only occurred four times since 1952.

S&P 500 index returns



Data through 4 May 2016
Source: Factset, BNP Paribas Investment Partners

The impact of the political party composition of the government is difficult to separate from other macro factors; the business cycle does not follow the political cycle. There is, however, a more likely discernible influence on particular sectors of the market. Legislation can have a significant impact on an industry, with health care and the financial sector being two clear and recent examples. There is a somewhat more discernible pattern in the sector returns and the configuration of government than there is for the market overall. The health care sector has outperformed the S&P 500 whenever there has been a Democratic president and a Republican or split Congress, while it has done so less often when the president was Republican and Congress was either Democratic or split (see figure).

S&P returns and party of president and Congress

Pairing	S&P 500	Energy	Materials	Industrials	Consumer Discr.	Consumer Staples	Health Care	Financials	Information Tech	Telecom Services	Utilities
D + R	14.8	25	0	50	50	50	100	50	75	50	50
D + S	14.0	0	0	50	100	50	100	50	50	50	50
R + R	13.4	100	100	67	33	0	0	67	67	33	67
D + D	4.5	75	38	75	50	13	50	38	63	13	25
R + D	2.7	60	30	40	40	70	70	50	50	60	40
R + S	-4.3	60	40	80	60	80	80	40	40	60	60

0-33 33-66 66-100

Data as of 3 May 2016. Note: S&P returns are inflation adjusted. First letter denotes party of president, second letter denotes party of Congress. D=democrat, R=republican, S=split in Congress Source: Standard & Poor’s, BNP Paribas Investment Partners

Returns for the energy and materials sectors have been almost the opposite, underperforming the S&P 500 under Democratic presidents and Republican/ split Congresses, but outperforming when the government was controlled by one party, either Republican or Democrat. Companies in the consumer staples sector generally did best with Republican presidents and Democratic or a split Congress.

The sector outlook for the next four years depends as much on the state of the economy as it does on who might eventually win the election. Regardless of the victors, the health care sector is likely to continue undergoing significant change and expanding its share of the economy. Which sub-industries will benefit and which will suffer will probably be determined more by politics, however. Returns for the financial sector, too, are likely to be driven primarily by the growth of the overall economy and particularly by Fed policy, as it seems unlikely the regulatory burden is going to lessen significantly, regardless of the election’s victors.

The technology sector is well positioned to expand under most political scenarios, and indeed in the past there has been little correlation between the sector`s returns relative to the S&P 500 and the composition of government. Technology is the most dynamic sector of the market, which bodes well for its own earnings growth. The sector will also benefit, however, due to the challenges facings companies in many other parts of the market. In an environment where nominal GDP growth is low and margins already high, companies are seeking new ways to cut costs and improve productivity. Technology companies should benefit disproportionately from this investment.

The results of the upcoming presidential election will likely have little impact on the trend of U.S. economic growth, but individual sectors could well be impacted by the legislation that results. The best investment strategy, however, is to focus on those with the best earnings growth potential instead of the best lobbyists.

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and Steven Friedman, Senior Investment Strategist
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