Market viewpoint

by Jose Canepa, Head of Asset Management

7th July 2015 update

Macro Environment

Since we last wrote we had two Non-farm payrolls numbers in the US, May was strong and June came slightly softer than expectations, with average hourly earnings weaker (flat) but broad measures of labour underutilization continuing to trend downward. Consumer spending showed signs of improvement in May with the first strong retail sales report of the year which exceeded expectations with strong revisions to previous months. The US Federal Reserve reiterated they will be monitoring economic data closely before any 'lift off' in interest rate increases and thus monetary policy remains extremely accommodative. The Greek situation is a complex and difficult one to predict. Financial markets have only seen a muted reaction as investors remain confident a resolution will be found despite the NO vote on the latest European austerity proposal (although this proposal was subsequently withdrawn by the EU creditors once the referendum was announced). It's worth noting however that the Greek economy is less than 1.5% of the European Union GDP, which in comparison, makes Greece contribute less to global growth than the US state of Connecticut. Greece is a complex and fluid political issue that is affecting investor sentiments in the short term. Europe is well prepared in case of a tale risk scenario. The key here is to be able to see through the Greek political situation, the Chinese equity correction and to focus in the US fundamentals and the FED's interest rate normalisation policy. Given where valuations are it's better to remain defensive, in particular in interest rate sensitive securities like investment grade bonds. It could be problematic for the bond markets to have a potential scenario in the coming months where the Greek problem is resolved or partially resolved and US data is coming in the strong side.

Given the magnitude of the correction in the Chinese stock market plus a potential Iranian deal, commodity prices in general remain under pressure; oil prices in particular. Despite the recent volatility and risk aversion, we have not seen the flight to quality into the USD that we would have expected. As we have mentioned previously, the strength of the US dollar could be an important factor for the US Federal Reserve when it considers the timing of the first interest rate hike.

Investors have reduced the probability of the first interest rate hike in the September FOMC meeting. As mentioned in the FOMC minutes, most members prefer indicating on a meeting by meeting basis the timing of the first hike rather than the Committee providing an explicit indication of the likely timing in a FOMC statement.

We still believe the US, as in line with previous years, will bounce back from a weak Q1 and lead the growth in the developed world. We should see inflation numbers gradually picking up over the medium term as lower commodity prices and the impact of the USD strength start to dissipate. Core inflation and wage growth will remain key indicators influencing the Fed behaviour.

Our view remains unchanged on interest rate normalisation and we still allocate a higher probability of a rate rise towards the end of the year. Our belief is that the Fed will raise rates in 2015, given that Fed Chair Mrs Yellen has expressed willingness to raise interest rates this year. Due to the unprecedented experience and characteristic of the US recovery, we believe that unlike previous interest hiking cycles, this one will be more gradual and patient in order to allowed economic growth to consolidate.

What does this mean for the US dollar?

We continue to believe that all ingredients are here to support the case for a stronger US dollar over the medium term. Growth prospects continue to be brighter in the US, the quantitative easing in Europe and Japan should continue to increase or at least maintain the interest rate differential between the US and the rest of the world. The latter coupled with inflation expectations, on a relative basis, continue to favour the US economy.

We note that the Yen is subject to different dynamics to the Euro and also acknowledge that being long US dollar is market consensus. We have recognized the substantial QE and the impact on the currency but there is a limit where policy makers will get concerned about the pace and the level of depreciation. With the recent risk aversion we have seen the YEN appreciating to the USD from the recent high. The YEN is showing signs of strength in time of market volatility. This currency was one of the best macro hedges in the subprime crisis.

Bonds

Given the recent data we acknowledge that the recovery is not totally smooth with some data coming on the weak side during the first part of the year. We still believe the US economy will improve in the coming quarters. Household saving rates are healthier, labour income is good, US corporations have strong balance sheets and local financial conditions remain accommodative. There is some headwind with a stronger USD that partially has been neutralized with the fall in energy prices.

The market expectations have been adjusting for the potential first interest rate hike later in the year, more in tune with our base case scenario. The FED needs to see that inflation will return to an acceptable level. The May payroll was strong as indicated by preliminary data releases and June payroll was decent but slightly below consensus. The FED will start to normalize rates from an extremely low level and in a gradual manner to avoid any negative knock on effect in the economic recovery process. The interest rate structure is likely to be lower than before the crisis and the real Fed funds rate could be close to zero.

US Treasuries and Bunds came under pressure in June as yields backed up but the recent July developments in Greece has seen stronger price action in these securities as yields have fallen.

As we mentioned before, the Greek issue has been well flagged for some time, European institutions have put in place firewalls and the Greek economy represent a small percentage of the European economy. The most probable scenario is that we could have a further risk aversion but this political crisis will have a resolution sooner rather than later and at the end what could stand out is a healthier US economy that will prevail in case of asset valuations.

Taking into consideration the scenarios in the US and Europe, we maintain our call for flat to slightly negative returns for US rates but recognise that there is going to be a cap in US yields given the low levels of nominal interest rates in Europe. We note that if nominal yields in Europe increase the cap for US Treasury yields could be higher.

The EMBIGD was down -1.56% with the index spread widening by+9bps, to end the month at +353bps. The CEMBI BD returned -0.90%, while spread widened + 6bps. The HY index component of the CEMBI BD sold off as much as the IG component, which was not the case in the sovereign index.

We need to put this EM performance in context. Financial assets and oil did not perform well in June. The S&P's monthly return was -1.94%, (the majority of this return took place in the penultimate day of the month) erasing almost all the capital gains for the year. Bunds (½% 02/25) returned -2.52% on the month, with the yield widening 27bps. The UST 10yr Note returned -2.03% and the YTM widened from 2.12% to 2.35% (+23bps).

Equities

We continue to remain optimistic on equity markets and expect to see positive returns over 2015.

We continue to believe that current market expectations of positive growth in the US over the coming quarters and an improving European GDP outlook should be positive for future equity returns.

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However, returns in the US could potentially be muted if the strong dollar negatively impacts future earnings and valuations become rich. We continue to see greater potential for European equities however as lower energy costs help strengthen corporate balance sheets and a weaker Euro and an easing in credit conditions should help to increase corporate earnings. As a result, we consider that exposure to European equities coupled with an FX hedge against further Euro weakness should outperform in the months to come.

We acknowledge the uncertainty surrounding Greece and the short term volatility seen in the Chinese equity market which could impact global risk appetite and equity markets in the near term. We also recognize however that Greece is an insignificant contributor to global growth (0.38% in 2014) and China remains the top performing main equity index in the world in advancing 16.3% in USD terms at time of writing. Chinese authorities and PBoC are working hard with consecutive interest rates cuts and implementing additional measures to ensure this year's GDP target remains on track. It is a difficult and complex process trying to rebalance the economy and a slight downside risk in the GDP growth forecast for the year remains.

We continue to expect between 4-7% from global equities in 2015. There remains the potential for higher returns with prolonged accommodative monetary policy and low commodity prices however a severe slowdown in the US or an increase in geopolitical risks could increase volatility.

Asset Allocation

We are close to neutral weight versus the benchmark between equities and bonds, and within bonds we remain allocated to EM debt via our EMOF product. Global bonds we believe will continue to offer low returns and exhibit limited upside, whereas the positioning within our EMOF product should provide income with a chance of capital gains based on relatively short duration assets. We expect EMOF to deliver 4-6% in 2015, outperforming global bonds and credit.

If you have any questions or wish to speak to someone about our investment products, please contact your relationship manager or email us at: **investment.enquiries@gibuk.com**

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