Market viewpoint

by the Asset Management team

GIB بنك الخليج الدولي

Key Points:

- **The weak US Q3 GDP data is likely to add to growth fears triggered by September's US non-farm payrolls data – a genuine cause for concern?**
- **Drop in US consumer prices largely due to transitory effects of weaker oil, pick up in prices of other goods suggest inflation due to rise**
- **IMF, WTO and OECD lower 2015 GDP forecasts in September**
- **Paradigm of low volatility in the markets coming to an end. Are spreads pricing-in the current lack of liquidity in the markets?**
- **The European and Japanese equity markets still represent a better investment than the US market**
- **Conditions continue to support case for stronger US dollar over medium term, Central Banks' policies will be key**
- **Current valuations across G7 bonds unattractive with potential upside, if any, to be limited going forward**

Macro Environment

Having asked the question in our last "viewpoint" of whether it is 'appropriate to raise rates if the market is not priced for it?' It would seem that the Fed's response on the matter has been fairly unequivocal. Rates were left at record low levels for the 82nd month in a row at the FOMC's September meeting. The usual verbiage around being ready to move this year nevertheless ensued, the undertone however seemed to strongly suggest that this would only be subject to no further unpleasant surprises. On October 2nd that surprise transpired in the form of a big miss in the September US Non-farm payrolls number, which included downward revisions to the prior month and showed no upward pressure on wages.

Risky assets certainly didn't enjoy this with Equities, Commodities, Emerging Markets and Spread Products performing poorly, which in turn resulted in a difficult third quarter for investors. Concerns about global growth in general, and particularly China, also didn't help wider investor sentiment. The IMF then added to investors' concerns, revising its GDP global growth forecast down from 3.3% to 3.1% for 2015 (as of October 2015).

Evolution of key US Macro

The big news on the US data front for September was the unexpected drop in the monthly Non-farm payrolls figure, which added just 142,000 versus 201,000 expected. August's 173,000 number was also revised down to 136,000. The unemployment rate however remained constant at 5.1% - effectively full employment by historical measures - which will undoubtedly keep the NAIRU discussion at the forefront of the Fed considerations. Wages were constant but remained on course for an annual increase of 2.2%.

There is clearly a fear that the slowing in payrolls over the past couple of months, as well as the sudden weakness in Q3 GDP, may reflect genuine weakening trends. However, as we have highlighted previously, some volatility in these readings is to be expected at this point in the cycle. Furthermore, when observed

over the last 12 months, the trend remains strong enough to keep the unemployment rate declining. Moreover the seems to be little support in the levels of jobless claims - having fallen to their lowest levels in more than 40 years - of a sudden slowing in the trend in payrolls gains (although we do not claim the two to be inextricably linked of course).

The Fed: where is this going?

As asserted in last month's piece, we see the Yellen Fed as having gone through great pains to reassure markets that the transition from zero rates will be as seamless and pain-free a process as possible. As such, to have moved in September– when market conditions look ill-equipped to deal with such a shock – would appear at odds with the FED's very intention to keep things in the market amicable. To this end, we should also bear in mind that considerations for the removal of emergency policy rates are likely to be very different to those of a bona fide monetary tightening.

We therefore see a delay in the interest rate normalisation as a likely course of action but we are certainly getting closer to its start. We contend that an early 2016 lift-off will be likely and expect a gradual path and extended period of interest rate rises. This will ensure that monetary policy remains accommodative for the foreseeable future.

A few words on China

We expect Chinese growth to be softer than Government projections, albeit we do not believe GDP growth is collapsing. IMF's recent Chinese GDP growth forecast was +6.8% (as of October 2015). We do not expect the Chinese stock market correction to have a major impact on the real economy, given that the Chinese equity market is small relative to the size of the real economy, with a tradeable value equal to 1/3 of GDP (for developed economies this ratio is around 100%).

What does this mean for the US dollar?

In the near term the market has priced in a delay of the FED's first hike, which is reflected in short end rates and the USD has adjusted accordingly versus the EUR. However, we continue to believe that all components 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. It is important to point out here that there could be an increase of the ECB quantitative easing program in terms of "size and duration". This interest rate differential coupled with inflation expectations, on a relative basis; continue to favour the US Dollar. We do acknowledge however that two of the three major central banks are not willing to see a large appreciation of the US dollar which could limit the size of any USD appreciation.

Bonds

During September and the beginning of October, US Treasuries were impacted by the market volatility and the recent soft US economic data, with the 10yr US Treasury Note yield tightening to 2.04% (August month-end: 2.23%). In the case of the 10yr Bunds, the yield compressed 20bps to 0.59%. The ECB has been vocal about potentially increasing its QE program and this will limit any selloff in European yields. However, it is important to point out is that there is limited value and upside in these securities. If unemployment data improves from the recent soft numbers, we can expect US Treasuries to adjust quickly given the limited secondary market liquidity.

Emerging markets had a difficult month with Brazil/Petrobras spreads widening significantly and repricing the entire asset class lower in particular the sub investment grade sector. EM currencies did poorly in September with the local market index down GBI-EM Global Diversified down 2.97%. In hard currency the EMBIGD was down -1.29% with the index spread widening by 44bps to end the month at +433bps. The CEMBI BD returned -1.18%, while spread widened by 48bps to 442bps. Year-to-end of September the EMBIGD and the CEMBI BD returned -0.07% and +0.85% respectively. If we focus on the hard currency asset class, valuations start to look attractive and opportunities are starting to appear. Credit differentiation and valuations remain important.

Equities

After the recent volatility, equity markets have recovered from being largely negative on the year and are now heading towards being flat year to date. We expect equities to continue their recovery and forecast that equities should return between 0 - 4% in 2015. We do however acknowledge that any surprise moves by either China to further devalue their currency or an unanticipated Fed move (not our base case) would affect risk appetite and thus equity returns. We believe any impacts will be more short term in nature and that the continuing search for yield within a low growth/return environment will result in more money flowing into equities as they continue to offer better value relative to government bonds which should be positive for equity returns over the medium term.

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. We expect global bonds to continue to offer low returns and exhibit limited upside, whereas the positioning of 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.

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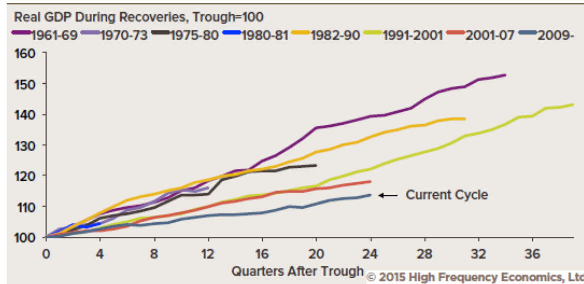
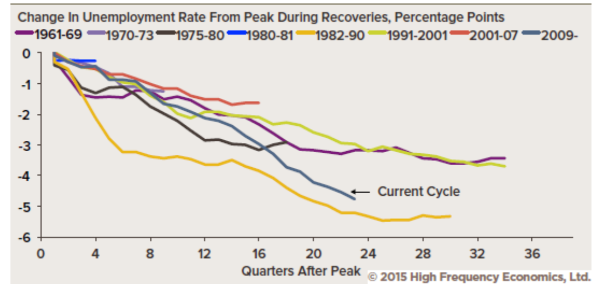
Charts and tables

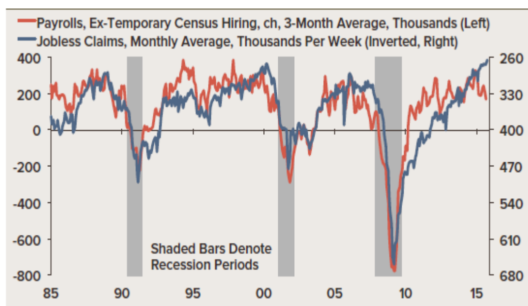
GDP growth has been weak by past standards



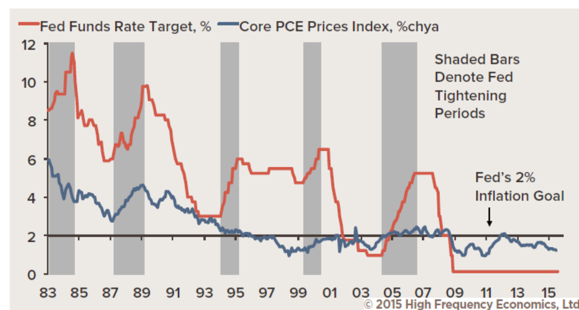
...yet unemployment rate has been falling rapidly



No corroboration in Jobless claims for drop in payrolls



Start of tightening does not require a pick-up in inflation



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