

## Key Points:

- **Pace of the US interest rate hike cycle, discrepancy between the Fed's stance and investors' expectations**
- **Slower Chinese growth coupled with revisions in FX policy**
- **Continued weakness in commodities**
- **Geopolitical tensions increasing**
- **New regulations negatively impact liquidity**

## Macro Environment

The US economy grew at a slower rate than previously estimated with the GDP advancing at 0.7% in Q4 2015. This placed the growth rate for the entire year of 2015 at 2.4%.

Employers in the US added more jobs than forecast, underscoring Federal Reserve Chair Janet Yellen's confidence that the economy is strong enough to withstand higher borrowing costs. The 292,000 increase in nonfarm payrolls in December 2015 was bigger than previously estimated. The median forecast called for a 200,000 advance. The jobless rate held steady at a more than seven-year low of 5%.

Hopes that the ECB would make up for the disappointingly small cut in its deposit rate (to -0.3%) with a decisive expansion of its asset purchase programme were dashed by the announcement that it has merely extended the programme from September 2016 to March 2017. The monthly purchases were left unchanged at EUR 60bn. The extension of the programme will raise the total programme from EUR 1.1trn to close to EUR 1.5trn. But that is only equal to about 15% of euro-zone GDP, well short of the 25% figures for the Bank of England's and Fed's programmes.

The Fed finally implemented the long expected raise in its benchmark rate on 16 December 2015 mentioning that there had been a considerable improvement in labour market conditions and that it expects inflation to rise over the medium term to 2% as the effects of declines in energy and import prices fade out and the labour market strengthens further. Given the economic outlook and recognizing the time it takes for policy actions to affect the economic outcome, the committee decided to raise the target range by 25bps.

The markets have now shifted attention to the future hike path of the Fed. The disparity between the FOMC signals and market expectations remains large. The median of the FOMC dot plots chart forecasts another 100bps of gradual rate hikes whilst a growing number of market participants do not expect any hikes during 2016. The FOMC forecasts a terminal rate of 3.5%, well above market expectations.

Whilst some parts of the US economy are showing solid numbers, it is not firing on all cylinders. Our expectation is that the Fed policy will continue to be dictated by a number of key data releases. Continued employment growth, a drop in U6 unemployment rate and an increase in wage inflation are key to Fed policy. Unlike the previous interest rate hike cycle, rate rises this time will be more

gradual in order to allow the economy to continue to recover with monetary policy remaining accommodative for the foreseeable future. We see this scenario as the most probable, more benign for risky assets and currently priced in by the markets. If for any reason US growth is much stronger or much weaker than expected, risky assets will have a more challenging time ahead.

## **A few words on China**

Chinese equity volatility will impact risk sentiment, though we do not expect the Chinese stock market correction to have a major impact on the real economy. The Chinese equity market is small relative to the size of the real economy, with a tradeable value equal to 1/3 of country's GDP (for developed economies this ratio is around 100%).

On the fundamental side investors will remain focussed on the growth of the Chinese economy. We are of the opinion that the Chinese economy is facing lower and more sustainable growth levels going forward as opposed to a hard landing and that the authorities will remain supportive in a targeted manner, delicately weighing continued support and rebalancing measures. Revisions in FX policy will continue to impact investor sentiment and markets globally.

January was a weak month for equities and fixed income, the US Dollar marginally weakened versus the euro and commodities continued their sluggish performance.

## **What does this mean for the US dollar?**

Our expectations of central bank policy divergence were again confirmed with the ECB becoming more dovish and the Fed more hawkish. The ECB could push the -0.30% deposit rate further into negative territory. We expect this theme to continue into 2016 and provide the platform for a stronger US dollar over the medium term. Interest rate differentials should increase between the US and Europe (Japan) which will continue to favour the US Dollar. The EUR/USD may approach parity during 2016. We do acknowledge that a stronger USD is a headwind for the US economy and could influence Fed's policy action. We note that the dynamics and technicals of the Yen are different and we have seen how this currency reacts to risk aversion during the first trading days of the year. Bank of Japan (BOJ) caught the market by surprise when it cut the deposit rate and brought it into a negative territory in an effort to return the country on the path of sustainable growth. In its statement BOJ mentioned the possibility of further interest rate cut if necessary.

## **Bonds**

As we mentioned in our previous Asset Allocation minutes the future Fed actions are likely to be data driven to some extent. We consider the labour market to represent the key variable influencing the Fed's behaviour in the near future. Labour income appears resilient, household saving rates are healthier, US corporates have strong balance sheets, the banking system is recovering and local financial conditions remain accommodative. The occasional headwinds mainly caused by the stronger USD have been partially offset by the fall in energy prices.

The market was well prepared for the first interest rate hike in December 2015. We expect the US treasury yields to be contained in terms of upside risk as marginally lower nominal yields in Europe will cap the upside in nominal yields in the US. During the month of January the yield on 10 year US treasury bonds declined to 1.92% from 2.27% reflecting increasing concerns about the growth pattern of the US economy and general international background.

The US will be hiking on the backdrop of a narrowing budget deficit, meaning the supply of treasuries will be reduced which should provide a good technical platform for these securities, whilst inflation expectations are well anchored. The BOJ decision will also help to constrain the upward movement in US treasury yields.

This scenario is benign for equity and spread products. We also recognize that the continued weakness in commodity prices will not have the same impact on inflation as before, as the largest part of the price decline is already behind us. The US wage inflation trend is highly important with a stronger USD serving as a mitigating factor for inflationary pressures going forward.

## **Equities**

Whilst we acknowledge the current market malaise and its impact upon equity markets we continue to remain optimistic and expect to see the market recover over the remainder of 2016.

We continue to believe that current market expectations of positive growth in the US over the year and an improving European GDP outlook, supported by accommodative monetary policy, should be positive for future equity returns for the remainder of the year.

In the US, we expect to see markets navigate a weak Q1 and eventually post positive gains over the remainder of 2016 as earnings growth concerns abate. European and Japanese equities should fare better in 2016 as lower energy costs, an improving money supply and weaker currencies positively impact corporate earnings.

Thus far in 2016 equity markets have seen significant volatility which we forecast to continue over the short term. We acknowledge the market's concerns but believe that the overall economic landscape hasn't changed significantly and certainly not enough to justify the negative markets seen thus far. Despite concerns surrounding commodities, emerging markets and China, we expect equities to recover and forecast that equities should grind back towards a flat year. We do however acknowledge that any surprise moves by central banks (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 the G7 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 a relatively short duration of assets.

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](mailto:investment.enquiries@gibuk.com)

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