Market viewpoint

by Jose Canepa, Head of Asset Management

April 2015 update

Macro Environment

Over the last few months, we have continued to highlight the positive influences on global growth through lower oil prices and lower headline inflation in addition to a stronger USD which has benefited the Eurozone especially. We have seen signs of improvement in lending conditions and growth indicators in the Eurozone aided by the start of QE which continues to instil confidence that Europe will at last sustainably climb out of recession. In the US however, we have seen some weak numbers in Q1 which have been affected by bad weather and port closures which were in contrast to the early employment numbers which have continued to be strong.

March largely continued with the theme with strong US Payrolls rising 295K in February, well above the 235K consensus. However over the last few days we received the March US Payroll numbers which were disappointing. Payrolls rose just 126K in Mar, well below the 245K consensus. The report could add to fears that the trend in growth is slowing, although there is no sign of weakening in jobless claims. For the moment, the market has given the US the benefit of the doubt and has shrugged off the weak report. The April numbers report will be a closely watched event with a second weak report likely to prompt a larger reaction from the market.

We continue to believe that the US will continue to grow relatively well with 2015 seeing GDP growth greater than 2%. Our belief is that Q2, much like in previous years, will show stronger numbers as the economy bounces back from a weak Q1. We should see inflation numbers gradually picking up over the medium term as lower commodity prices and USD strength influences start to dissipate. Core inflation and wage growth will remain key in influencing Fed behaviour.

As detailed previously the big policy update for the year was the QE announced by the ECB. The program started in March, with Eurozone central banks buying bonds worth EUR52.5bn during the month. We continue to believe that QE, the boost from both a weaker EUR and lower commodity prices and the improvement in credit conditions will help fight deflation in the Eurozone and should spur economic growth in the region. In the short term we acknowledge that solving the Greece problem continues to be a key risk event although we also expect a Grexit to be an unlikely event.

We continue to see low yields within Europe as the QE continues to influence pricing. The US 10 year yield is currently around 1.90% dropping around 10bps over the previous month. Our expectations are that, without a worsening of economic data, yields will continue to rise over the remainder of the year especially if the Fed raises interest rates towards the end of the year, which remains our base case scenario. However, we do note that the nominal yield differential between US and Eurozone rates will limit how much further US yields can rise.

Fed watch continues to be an important driver of markets. As expected, the signal that officials will be "patient" was dropped from the March FOMC statement. As expected, the significance of the dropping was downplayed, with no set plan on the start of normalization other than that it will not be at the next meeting in April. In addition, there was a sizeable lowering of the median fund rate projections with the end of 2015 forecast now 0.625% instead of 1.125%. Our position remains the same with our expectation that there is a higher probability of a rate rise towards the end of the year. Our belief is that the Fed will raise rates in 2015 but unlike previous cycles will be more patient as they allow the market to digest the tighter monetary policy.

On the geopolitical front, we acknowledge that risks remain in Russia although we note that the current ceasefire is largely holding and that any flare ups are likely to be small in the short term. The current events in Yemen also require acknowledgement but our expectations are that this is unlikely to affect the global economy unless Oil is impacted materially.

What does this mean for the US dollar?

All ingredients are here to support the case for stronger a US dollar over the medium term. Growth prospects continue to be bright in the US, the recent quantitative easing in Europe and Japan will continue to increase the interest rate gap between the US and the rest of the world and inflation expectations, on a relative basis, should 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. In the short term, however, we have seen a small pullback in the US dollar and we are likely to see the US dollar trade in a tighter range until further evidence presents itself.

Bonds

The US economic data has been relatively mixed and there are some signs pointing to a softer economy. This has prompted a downwards revision to the first quarter GDP numbers. Despite the recent weaker economic data and the US dollar strength that has been supportive of a low inflation environment, we continue to believe the Federal Reserve will hike rates during the second half of 2015. This is due to our expectations that the US economy will do better in the coming quarters given US households are in a better shape in terms of savings and spending capacity and US corporations have strong balance sheets.

The FED fund rate is at an extremely low level and the FED has clearly stated its intention to hike. However we expect the approach to the exit strategy to be completely different from any previous rate hike cycle, in the sense that the FED will hike very gradually. A rate hike, even minimal, would be a sign of confidence and an indication that the economy is recovering and will do better in the coming years. The FED also has a window of opportunity to start the normalization process in an environment where the ECB and BOJ are still expanding their balance sheets.

In Europe the ECB QE program has had a major impact on rates, with the yield in the 10 year German Bunds approaching zero. This environment of low European government nominal yields is expected to be prolonged and is affecting European currencies as investors search for opportunities in other regions and asset classes.

We believe that the possibility of a Greek exit from EMU will affect markets considerably; albeit we do not believe this event should be considered as a base case scenario.

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.

US Treasuries performed strongly in March but credit markets had a mixed month, and spreads widened across the board. EM hard currency spreads only marginally widened (around 10bps), allowing indices to post positive absolute returns. US High Yield credit widened more significantly (around 30bps) and posted their first monthly negative return of the year.

Despite the recent spread widening, US and European HY bonds remain tighter than at the beginning of the year (-21bps and -48bps YTD respectively). EM spreads are around 15bps wider.

Our base case scenario of a gradually improving global economy combined with a mild and very prudent rate normalisation by the Fed is overall supportive for spread products in the medium term. In the short term however, spreads could be vulnerable to market shocks and potential spikes in volatility.

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Equities

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

We feel that the US will continue to drive global growth and thus equity returns. However, expectations of performance in the US will reduce if valuations start to become rich and if the dollar strength negatively impacts future earnings. European equities continue to show greater upside as corporate balance sheets strengthen due to lower energy costs, a weaker euro and an easing in credit conditions which should allow corporate to deliver increased 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 expect between 4-7% from global equities in 2015. There is 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 now at equal weight for bonds versus equities, 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.

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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