Market viewpoint

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August 2015 update

Macro Environment

Over the last month we have seen Non-farm payrolls for July continue their positive trend and post another gain over 200k with average hourly earnings mildly stronger. We also saw a further decline in the U6 measure of unemployment to a seven-year low of 10.4%. Economic activity continues to show signs of stabilisation with PMI surveys in expansionary territory whilst housing and industrial production remain resilient. Growth for Q1 was revised up from -0.2% q/q saar to 0.6% saar whilst the advance estimate of US Q2 GDP was 2.3% q/q saar pace with personal consumption expanding strongly. The US Federal Reserve reiterated they will be monitoring economic data closely before any 'lift off' in interest rates and thus monetary policy remains extremely accommodative. 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 and other Fed members have expressed willingness to raise interest rates this year. However, we believe that unlike previous interest hiking cycles, rate rises will be more gradual and patient in order to allow the economy to continue to recover.

Even if, as expected, interest rate normalisation begins at the end of 2015, the expected gradual path of interest rate rises will ensure that monetary policy remains accommodative for the foreseeable future. The emergency reasoning for an interest rate almost at zero has passed. We now see increased M/A activity, a much more stable US banking system and solid, but not spectacular, US earnings supporting 'lift off', or 'crawl off' as many investors have begun calling it due to the expected cautious approach by the Fed.

As we predicted, growth in Q2 has bounced following a weak Q1 which we expect to continue and lead the growth in the developed world although the improvements have not been as widespread as expected. We should see inflation numbers gradually picking up over the medium to longer 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.

One key area of the economy that the Fed is closely watching is inflation. In the short term core inflation remains sticky at 1.8% y/y and this looks unlikely to hit the 2% target any time soon. Indeed, Brent Oil plunged 19% over the month on concerns of over supply at a time when global growth expectations are being lowered. The lower commodity prices will no doubt boost developed economies providing higher disposal income for consumers.

The volatility in Chinese equity markets would also have weighed on commodity prices. A further 14% decline in July for Chinese equity markets has ensured further actions by the PBoC and the regulators to try and stem the market uncertainty. At time of writing the PBoC announced a move to devalue the Yuan by adjusting the Yuan fix by 1.9%, the largest on record. The adjustment corrects some of the strong appreciation of the currency and is a deliberate attempt to align the fixing with the market.

In Europe the dark cloud that was Grexit finally cleared after intense negotiations with the EU leaders finally finding a platform for an agreement to be found. Despite Greece being minor contributors to global growth the political uncertainty emanating from the region added to risk aversion so the resolution has taken away that uncertainty and fear of contagion. Europe's recovery is progressing steadily with improvements seen in economic activity; PMI surveys suggest expansion, consumer spending is improving across the region and the key economy of Germany are seeing more upside surprises than disappointments.

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 Dollar.

We note the Yuan devaluation and the sell-off in commodity prices will also aid US Dollar strength and acknowledge that being long US dollar is market consensus. We believe the US Dollar will continue to trend higher over the short to medium term.

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 resilient, US corporations have strong balance sheets, the banking system is recovering 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.

Market expectations have been adjusting for the potential first interest rate hike later in the year, more in tune with our base case scenario. On average, payroll numbers are coming on the healthier side. The overall US economic background is not supportive of policy rate close to Zero for too much longer. 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. As we mentioned before, interest rate policy will remain accommodative. The interest rate structure is likely to be lower than that before the crisis and the real Fed funds rate could settle closer to zero in the coming years.

During July we had a reversal in yield compression in US Treasuries rates and Bunds. The reversal was on the back of concerns surrounding Chinese growth expectations, revision to slightly lower global growth and the impact in commodity prices. The yield in the 10yr US Treasury Note is near the 2014 year end level 2.12%. We recognized that lower commodity prices are positive for growth in the developed world and is a deflationary factor. This will help the Fed in combination with its monetary policy to anchor the yield in the back end of the US Treasury curve.

The most probable scenario in the short term is that we could have a further risk aversion given the Chinese slightly softer economic growth prospect. Chinese authorities are implementing a variety of economic policies in other to meet expected GDP growth. At the end what could stand out is a healthier US economy that will prevail in the case of asset valuations.

In relation to Emerging Markets, given commodity performance during July the hard currency indices on average had a slightly positive month. The EMBIGD was up +0.49% with the index spread widening by +14bps to end the month at +367bps. The CEMBI BD returned -0.05%, while spread widened + 17bps.

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.

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 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 short term volatility seen in the Chinese equity market which could impact global risk appetite, equity and commodity markets in the near term. Chinese authorities and PBoC are working hard

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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