7th September 2016

Key Points:

- Future economic environment in the post-Brexit vote world clouded by uncertainty
- Political risk increasing and difficult to quantify
- Accommodative policies of central banks continue
- Pace of the US interest rate hike cycle

Macro Environment

The market impact of the Brexit vote has been limited so far and the same holds true for the US Presidential elections. The central banks' monetary policies are reflected by the markets with asset valuations getting richer and the search for yield continuing.

The FED's interest rate hike rhetoric has become more pronounced closer to the end of August and also during Ms Yellen's Jackson Hole speech. The fact is that US growth was soft in the first half of the year. However, the economy is likely to pick up momentum during the remaining part of the year as capital investment should increase, inventories build-up, easing effects of a stronger USD, increasing consumer spending and a well-capitalised banking system.

The US economy seems to be on the right track thus strengthening the argument for a FED rates increase. The FED's main concerns from June (Brexit, liquidity conditions and soft unemployment number in May) are no longer so pressing. The most recent US Nonfarm payrolls number for August (151k) appeared satisfactory given the unemployment rate of 4.9%, and in isolation is above the "breakeven" rate - the number that Fed officials believe is consistent with unchanged labour market slack in the medium term. The current nominal FED funds rate is very low and implies a negative rate in real terms. Such a level may be justifiable in an emergency situation but not necessarily now, 8 years after the beginning of the crisis. The combination of a slowly improving economy, lower unemployment and a negative FED funds real rate is likely to prompt the FED to start the interest rate normalization in the not so distant future. The primary aim of this tightening cycle is not to squeeze growth or target inflation, it's just the normalization of emergency interest levels needed after one of the worst financial crisis.

The FED is concerned about the impact of persistently low interest rates on savers, asset valuations and the health of financial institutions. As such, we expect the FED to implement one interest rate hike of 25bp before the end of this year. We do not expect the FED to hike twice this year because of the dynamics of the economic recovery. If the hike is too early or aggressive, it could strengthen the US dollar and have a potential knock-on effect on growth and result in a large policy divergence from other major central banks. The FED and investors are also contemplating the potential risks stemming from the US Presidential elections.

The current global political landscape is complex with populist parties gaining ground worldwide as evidenced by the swings in political power in Austria, Germany and the UK. The United States seems to follow the same trend and this could make the result of the upcoming presidential elections tighter than expected.

If our base case scenario of the FED slowly normalising rates over a longer period of time and other central banks keeping an accommodative monetary policy holds, we expect equities and spread products like Emerging Market fixed income (hard currency) to continue to be well supported.

What does this mean for the US dollar?

Given improving growth prospect for the US, interest differential and divergence in monetary policy, in the medium term the US dollar should perform better than other major currencies.

The value of the USD is a fragile equilibrium of interests going forward. In the political landscape, a stronger USD does not benefit the other main central banks and we acknowledge that a stronger USD could influence Fed's policy actions.

PBoC decided to slightly devalue the Yuan given the strength of the USD after Brexit as it is clear that China has a limited tolerance to lose more export revenue due to the exchange rate. Interestingly the magnitude of such adjustment is not that different from the adjustments made by the PBoC last year.

Bonds

Given the solid July US payrolls number and slightly more hawkish tone from FED officials towards the end of August, US rates pulled back slightly (US Treasury 10yr Note YTM widened +14bps to 1.58%).

As mentioned before, FED funds rates remain at emergency levels several years after the global financial crisis whilst in G7 countries nominal yields are very low or negative. We do not consider the monetary policy targeting negative nominal rates to be a solution for growth; there is a limit to central bank policy. We have seen its effects in Denmark, the first country to adopt negative rates, where the private sector is saving more than when the rates were positive and companies are not investing more despite low rates. Consumers and companies probably view the extreme interest rate policy as an indication of a crisis with an unpredictable outcome and this has driven their behaviour. The G7 bond yields are in a historically low range with limited room for central banks to pursue monetary policy into further nominal negative territory.

We expect the FED to hike this year by 0.25%. The market can absorb this hike, however we do not see the market prepared for two hikes this year. Two hikes do not represent our base case scenario. As mentioned before, any pull back in US rates should be contained given the low /negative yields in Europe and Japan.

With nominal G7 yields at the lowest levels in decades, and while central banks are still continuing with accommodative monetary policies, the global search for yield and risky assets continues.

For investors seeking yield in fixed income assets, EM credit (cash USD-denominated bonds) offers more attractive yields (or spread over US treasuries) on a relative basis, though a close focus on fundamentals remains essential.

Equities

A sense of calm swept over financial markets during August with equity markets a lot more subdued as the summer month ensured limited volume and limited volatility. The Bank of England eased policy more than expected during the month which helped support risk appetite in Europe whilst the US ambled sideways with stable data and the main equity index exhibiting low volatility moving less than 1% every day over the month. The MSCI World index nudged up 8 basis points over the month and has now gained 5% over 2016.

We remain of the view that the US recovery continues with improving economic data and accommodative monetary policy helping equity markets to steadily grind higher. In Europe the picture is unclear as the full ramifications for the UK leaving the EU are unknown but we continue to see a steadying of economic data whilst the recent earnings season was also on the positive side. The UK has remained remarkably resilient with solid economic data and vibrant equity markets but we remain cautious and will closely monitor the UK as Brexit negotiations progress slowly. We still believe that central banks remain a key driver of risk in equity markets with the majority of central banks continuing with the rhetoric of low rates for longer which is supporting risk assets. In the US however, the Federal Reserve are seemingly nearing the second hike in their normalisation cycle although rates will remain accommodative and we feel financial markets will absorb the probable imminent rate hike effortlessly. Further rate increases in the short term could weigh on risk appetite however.

We remain of the view that equities could be positive over the rest of the year but we now require the UK’s exit from the EU to be well handled and clearly communicated with limited further shocks to the financial system. We continue to believe that investors will continue to search for yield within a low growth/return environment which 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. Going forward we believe there is limited value to investors in G7 bonds whereas the positioning of our EMOF product should provide income with a chance of capital gains based on a relatively short duration 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**