Market viewpoint

by the Asset Management team

Key Points:

- **Slowdown in Chinese growth to hasten revision of domestic FX policy**
- **Black cloud of commodities slide to ensure persistent disinflation into 2016**
- **Pace of Fed's interest rate hike cycle at odds with market expectations...we agree with the markets**
- **Increasing tensions to add to unforgiving geopolitical backdrop**
- **More regulation = less liquidity across all markets going forwards**

Macro Environment

A litany of market swoons heralded in 2016 as equity market volatility, precipitous declines in commodities and oil, stalling global GDP and a Chinese growth picture creeping further and further off the boil coloured the newswires. With the main piece of good news being that, frankly, things are not as bad as they could be, there has been precious little to balance out the negativity. Although it can be said that the Fed's decision to finally begin the interest rate normalisation process last month - prompted by encouraging declines in the unemployment rate – it remains to be seen how aggressive their schedule of future hikes will be given the wider global context.

Evolution of key US Macro

The US economy grew at a slightly slower rate than previously estimated between July and September. The economy expanded at an annual pace of 2.0%, according to the Bureau of Economic Analysis' third estimate of GDP, down from 2.1% in the second estimate. Employers in the US added more jobs than forecast in November, underscoring Federal Reserve Chair Janet Yellen's confidence that the economy is strong enough to withstand higher borrowing costs. The 211,000 increase in payrolls followed a 271,000 gain in October that was bigger than previously estimated. The median forecast called for a 200,000 advance. The jobless rate held at a more than seven-year low of 5%.

Whilst some parts of the US economy are showing solid numbers, it is not firing on all cylinders. Our expectation is that 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 and thus interest rate hikes. 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 believe that this scenario is the most probable, already priced in by financial markets and thus more benign for risky assets. If US growth is much stronger or much weaker than expected however, risky assets will have a more challenging time ahead.

The Fed: where is this going?

The Fed finally implemented the long expected raise in its benchmark rate on 16 December 2015 mentioning that there has been 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.

Financial markets have now shifted attention to the future hike path of the Fed. The disparity between the FOMC and market expectations remains significant. The median of the FOMC dot plots chart forecasts another 100bps of gradual rate hikes over 2016 whilst the majority of market participants expect only 50bps. The FOMC forecasts a terminal rate of 3.5%, well above market expectations.

The future Fed actions are likely to be largely data driven. The U6 underemployment rate is on track to approach 9.5% around the end of 1Q 2016, which is around the level where the Fed started hiking in the last cycle (June 2004). We reiterate our belief that the labour market is and will continue to be the key variable influencing the Fed’s behaviour in the imminent future. Labour income is resilient, household saving rates are healthier, US corporates have strong balance sheets, the banking system is recovering and local financial conditions remain accommodative. Though there have been some headwinds caused by the stronger USD, these 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 also believe that US treasury yields in the US will be contained in terms of upside risk as marginal lower nominal yields in Europe will cap the upside in nominal yields in the US. The US will be hiking with a 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 expectation are well anchored.

A few words on China

Despite Chinese equity market volatility impacting risk sentiment, 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 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 continue to believe that growth will not collapse and that authorities will remain supportive in a targeted manner, delicately balancing continued support and rebalancing measures. Revisions in FX policy will continue to impact investor sentiment and markets globally.

What does this mean for the US dollar?

Our expectations of central bank policy divergence were again confirmed during the month with the ECB becoming more dovish and the Fed more hawkish. Despite a rate cut in December, the ECB could push the -0.30% deposit rate further into negative territory. We continue to believe that this theme of accommodative monetary policy by the ECB will continue into 2016. This provides the platform for a stronger US dollar over the medium term. Interest rate differentials should increase between the US and Europe, and potentially Japan, which will continue to favour the US Dollar. In relation to EUR/USD we believe there is a decent probability that in 2016 EUR will break below parity. We do acknowledge that a stronger USD is a headwind for the US economy which could influence policy action by the Fed. 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.

Bonds

As we learnt this year neither European nor Japanese bonds offer any value at current yield levels. If we take the JPM GBI bond index USD hedged, the most probable scenario is that yields widen in the US, Europe and Japan by +25bps, the index will return 0% to -0.40%. Under a more bullish scenario where rates in the US pull back +35bps and tighten -25bps in Europe/Japan, the expected return for next year is in the range of +1.5% to +2%.

We expect EMOF to deliver a net return of 4/5% in 2016, outperforming global bonds and credit.

Equities

We continue to remain optimistic on equity markets and expect to see positive returns over 2016.

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

In the US, we expect to see marginally positive gains for 2016 as earnings growth although positive, will remain muted as a stronger dollar continues to impact earnings. European and Japanese equities should fare better in 2016 as lower energy costs, an improving money supply and weaker currencies positively impact corporate earnings.

Despite volatility towards the end of the year, equity markets were generally positive over 2015 and we expect that to continue. Despite ongoing concerns surrounding growth in China ensuring a weak start to the year, we expect equities to continue their recovery and forecast that equities should return between 4-6% in 2016. 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 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.

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**