Viewpoint

December 2016

Key Themes for the next 3-6 months

- **Brexit continues to cast uncertainty**
- **Mr. Trump victory is a game changer**
- **Central banks' monetary policy is less clear, potentially less accommodative**
- **Europe's major banks' liquidity/solvency is in doubt, particularly in Italy**
- **Europe faces an intense election calendar in 2017**
- **Populist movements gaining momentum**

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Macro Environment

In the UK, consumer price inflation decelerated slightly to print at 0.9% YoY in November, whilst the producer price inflation is picking up. The yield of the 10 year Gilts rose 17bps to 1.42% between 31st of October and 30th of November. Theresa May will be announcing the government's Brexit plan before triggering Article 50 in March next year. The UK Supreme Court is currently determining whether parliament has the right to trigger article 50. Michel Barnier, the European Commissioner for Internal Market and Services, said that Brexit must be an inferior deal for Britain than EU membership, and curbs on free movement were not compatible with full access to the single market. To offset the risks of Brexit on the economy, a potential cut in corporate taxes are on the table. Whilst negotiations continue, the actual impact of the Brexit vote has been limited so far with retail sales up 1.9% in October (against expectations of 0.5%) and manufacturing PMI (53.4), construction PMI (52.8) and Services PMI (55.2), all suggesting growth and a lift in price inflation. This mixed picture makes it difficult to know what the next move for the Bank of England is, a rate hike or a rate cut. In Europe, data continues to be resilient with Euro Area flash manufacturing PMI (53.7) and flash Services PMI (54.1) for October both suggesting growth and coming ahead of expectations. This in turn can lead to a light tapering in expansionary monetary policies, especially if inflation picks up. Due to a pick-up in economic activity and signs of inflation in the Eurozone economists have started to bring forward the QE phase-out by the ECB.

In the US, data coming in is fairly strong and economic optimism is at multi-year highs. US final Q3 GDP growth was 3.2% (higher than the preliminary reading of 2.9%) and ISM Manufacturing PMI was at 53.2, higher than expected (52.1) and suggesting growth (though impacted by some one-offs). Consumer sentiment came at (107.1), better than expected and the highest reading since August 2007. The job market continues to be solid with payroll for the month of November coming at 178K as unemployment dropped to 4.6% (from 4.9%). On the other hand, participation rate dropped to 62.7% from 62.8%, suggesting that part of the drop in the unemployment rate was due to more Americans leaving the work force. Wage growth fell slightly MoM but is still up YoY by 2.5%. We believe that wage growth should pick up faster as the labour market tightens, which will put pressure on inflation and corporate margins. Going forward, a likely increase in investment, infrastructure spending, and inventories build-up should help support the economy given healthy consumer spending and a well-capitalised banking system.
The US economy seems to be on the right track with the Fed basically meeting both of its mandates – low unemployment (4.6%) and underlying inflation rate at around 2%.

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The political landscape is at the forefront of investors' minds with the victory of Mr. Trump in the United States and the Republican Party gaining control of both the Senate and the House of Representative taking centre stage.

Markets priced in quickly expansionary fiscal policies which would lead to higher US economic growth, higher inflation and faster hiking of interest rates.

Over the next couple of months, attention will turn to the drafting of the US budget in February and the debate over the debt ceiling in March 2017, especially as Republicans (who used to oppose to raising the debt limit) control both the Senate and the House of Representative. We will be looking for more clarity on what realistically can be achieved from Mr. Trump's ambitious plans.

World trade is set to grow at 1.7% in 2016; the slowest pace since the financial crisis and below April's forecast of 2.8%, according to the World Trade Organization. The forecast for 2017 has also been revised lower to a range between 1.8% and 3.1%, down from 3.8%. The slower growth is driven not only by the slowing growth in developing nations, such as China and Brazil, but also by North America, according to the organization. The question is what Mr. Trump will do about The North American Free Trade Agreement (NAFTA) and his promises of imposing tariffs on Chinese and Mexican imports.

Central banks are expected to be less accommodative in their monetary policies going forward as we expect the Fed to hike rates once this year and twice next year (and here the risk is to the upside). As implied by the market, the probability for a hike of 25 bps this year stands at 100%.

OPEC, the oil cartel, and Russia agreed on the 30th of November to cut oil production by 1.2mn and 300k barrels a day, respectively, to restore the balance in the oil market. The oil price rallied ever since by c.15% to reach USD 53.75 as of the 6th of December.

What does this mean for the US dollar?

The interest rate differential is in favour of the USD. In addition, the expectations of faster interest rate hikes in the US, provides support for the USD. We believe, however, that the USD has appreciated too fast too soon. For instance, spot USD/JPY reached 114.5 from 104.8 during the month of November. Consequently, we believe that the upside in the USD is limited going forward.

Bonds

Following the victory of Mr. Trump and given the solid footing of the US economy and the rising expectations of a FED hike, US rates pulled back with US Treasury 10yr Note YTM widening c.55bps to 2.38% between October 31st and November 30th. This has led to yields across developed and emerging markets to pull back.

The combination of higher rates and the potential alterations in international trade arrangements affected the sentiment around emerging markets. Nevertheless, the spread widening in the main indexes (i.e. EMBI GD and the CEMBI BD) has been limited.

We continue to believe that for investors seeking yield in fixed income assets, EM credit (cash USD-denominated bonds) offers more attractive spreads on a relative basis, though a close focus on fundamentals remains essential, especially as yields are close to its historical lows.
In our opinion, the yield on US treasuries has reached its upper boundary and that value is being created given the strengthening fundamentals of emerging markets.
The key here is what will happen to commodity prices going forward. Q3 US growth has been strong (3.2%) and going into 2017, markets are pricing in growth of 2.3% to 2.5% for the full year.

This economic backdrop (coupled with OPEC members agreeing to cut oil production by 1.2mn barrels a day) should be supportive of commodities and EM hard currency fixed income as an asset class.
We expect this environment to create good entry levels for investors in the EM fixed income hard currency space.

Equities

November was a positive month in equity markets as despite Donald Trump shocking the world and winning the USD election, equity markets continued to move higher. The pessimism that greeted his gaining popularity pre-vote, faded away as the results filtered through and attention turned to the potential positive impact his pro-business policies could have. Mr Trump was gracious in victory and financial markets seem to be willing to give the president in waiting the benefit of the doubt until his tenure begins. US equities benefitted from this risk appetite as the S&P500 continues to march back towards record highs and gained another 3.7% over the month. Local equity markets were mixed but the strong US performance dragged global benchmarks higher with the MSCI World index advancing 1.4% over the month.

We remain of the view that the US recovery continues as the economy nears the Federal Reserve's dual mandate targets regarding inflation and employment and a second rate hike is priced in for December. However, we remain of the view that policy will remain accommodative with a cautious approach towards the pace of policy normalisation. Indeed, economic data continues to stabilise helping equity markets to steadily grind higher although we acknowledge that the largely unknown policies of Donald Trump and his new government provide an overhang to risk which we will continue to monitor closely.

In Europe the picture is unclear as the full ramifications for the UK leaving the EU are unknown but economic data remains resilient. We remain cognizant of the fact that investor's concerns around European banks remain and the political landscape in the region could also impact sentiment. Despite the Brexit vote, the UK economy continues to perform strongly but we remain cautious and will closely monitor the UK as Brexit negotiations progress slowly although politicians are becoming increasingly vocal on the topic. We still believe that central banks remain a key driver of risk in equity markets although we feel that central banks could move to a slightly less accommodative stance as the year, and 2017 progresses. In the US however, the second interest rate hike is fully priced in.
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 assuming a soft UK exit from the EU with limited further shocks to the financial system. We continue to believe that investors will keep on searching for yield within a low growth/return environment.
This would result in more money flowing into equities as they offer better value relative to government bonds.

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**

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