Viewpoint

GIB

February 2017

Key Themes for the next 3-6 months

- The victory for Donald Trump in the US presidential elections has introduced significant uncertainty in global markets
- The Brexit vote continues to impact the economic outlook in the UK.
- A number of European countries are facing a challenging year with elections coming up
- Central banks' monetary policy is less clear with the potential for slightly less accommodative measures, especially in the US
- OPEC has been successful in reaching an agreement in its meeting over production cuts
- Global trade is expected to grow at the slowest pace since the financial crisis, according to the World Trade Organization.

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Macro Environment

World trade is expected to grow at 1.7% in 2016; the slowest pace since the financial crisis and revised down from April's forecast of 2.8%, according to the World Trade Organization (WTO). The forecast for 2017 has also been adjusted downwards to a range between 1.8% and 3.1%, from previous 3.8%. The reduction in trade growth is driven not only by developing nations, such as China and Brazil, but also by North America, according to the WTO.

Trump's presidency is likely to impact global trade, as he is a strong opponent of The North American Free Trade Agreement (NAFTA) and has on several occasions proposed the introduction of tariffs on Chinese and Mexican imports. Before Trump does anything, growing budget deficits are already on course to push federal debt as a share of GDP to record levels. This will make it more difficult to deliver on promises to cut taxes and boost spending.

In the US, data coming in is fairly strong and economic optimism is at multi-year highs. The American economy expanded at an annual estimated rate of 1.9% in Q4 2016. In Q3, real GDP increased 3.5%. The deceleration in real GDP in the fourth quarter reflected a downturn in exports, a pickup in imports, a deceleration in personal consumption expenditure, and a downturn in federal government spending. Full year real GDP increased 1.6% in 2016 (that is, from the 2015 annual level to the 2016 annual level), compared with an increase of 2.6% in 2015.

The repeal of the Affordable Care Act (ACA) and a large infrastructure package represent some of the major fiscal policy changes on the spending side. A cut in effective corporate tax rates is also broadly expected and priced in. The corporate tax reform proposal is complex, with the switch to a destination-based tax with border adjustment (DBTBA) being the most actively debated part. We expect the upward pressure on wages to intensify (December hourly earnings up 2.9% y/y, the most since 2009) 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 overall and a well-capitalised banking system. The US economy seems to be on the right track. The market is pricing in one to two interest rate hikes in 2017.

Central banks are expected to be less accommodative going forward as the Fed is preparing to hike rates. We expect central banks to be cautious about rate normalization with only gradual rate hikes. The ECB has mentioned that it will not end its bond purchasing program without first tapering it, suggesting that it could run beyond the scheduled end-date of March 2017.

Europe is facing a politically challenging year with elections coming up in France, Germany and the Netherlands. The Brexit vote and Trump victory have demonstrated that populist anti-establishment sentiments are gaining a growing support of electorate. Public polls suggest that politicians such as France's Marine Le Pen and the Netherlands' Geert Wilders are increasing their chances of winning power in coming months. Victories for parties such as Le Pen's Front National and the German AfD could trigger Brexit-style referendums in their countries which might undermine the very foundations of the EU.

The oil prices have increased as OPEC and other major crude-producing nations agreed in November to impose quotas on its members for the first time in eight years, in an effort to stem a supply glut that had depressed crude prices. OPEC enlisted support from 11 other producers on 10 December 2016 in an historic deal to remove as much as 1.8 million barrels of oil a day from the market. OPEC expects to decide whether to extend the cuts at its bi-annual meeting in Vienna in May.

What does this mean for the US dollar?

We have to recognise the US Dollar has appreciated significantly during the last two years, we believe this currency will remain well supported but volatility could pick up going forward. Trump's economic policies have the potential to support the US Dollar and this is in an environment where the US has the best prospect of economic growth of the G3 economies. The US Federal reserve monetary policy cycle and the political uncertainties in other countries could also provide support for the US Dollar.

Fixed Income

Following the victory of Mr. Trump and given the solid footing of the US economy the rising expectations of FED hikes plus Trump's potential economic policies, US rates pulled back with US Treasury 10yr Note YTM widening c.48ps to 2.31% between 31st October and 12th January. The 10 year treasury yield peaked at c.2.60% in December while the emerging markets held well. During January to February 7th 2017, the 10 year US treasury yield has traded in a range between 2.47% and 2.39%, trending towards the lower part of the range. In the case of the European bond market rates pull back across the board during January, as we mentioned previously we don't believe the European bond market offers any value to investors. With the US Treasury market flat performance during this period and the recent pull back in the US Dollar, EM hard currency indices have performed well with spread tightening across the board. In general EM equities and local bond markets have performed well; the exception has been the Turkish Lira.

Emerging market fundamentals remain strong relative to developed markets and growth prospects are improving in some of the major economies. Emerging markets will be a significant contributor to global growth going forward, with forecasts in the upper range of the last 5 years and likely to keep commodity prices well supported.

In view of these technical and fundamental considerations, we believe value will be created and there are likely to be good entry levels for investors going forward.

Equities

Financial markets began the year how they left off in December with improving economic data and risk appetite pushing equity markets higher. Donald Trump was inaugurated in as the new president of the United States with optimism around his appointment still driving risk assets higher. For the time being, markets seem willing to give Mr Trump the benefit of the doubt. Indeed, expectations around his pro-US, pro-business policies continue to grow and helped drive US equity markets to record highs in January. Over the month the S&P500 and Dow Jones both hit record highs whilst the MSCI World index gained 2.4%.

We believe that the US recovery continues as the economy nears the Federal Reserve's dual mandate targets regarding inflation and employment and we expect Mr Trump to employ policies that promote domestic growth. We note that the market is now pricing in only one to two interest rate hikes in 2017, lower than an initial three hikes expected, which reemphasises our view that policy will remain accommodative with a cautious approach towards the pace of policy normalisation. Indeed, we expect economic data to continue to stabilise, helping equity markets to steadily grind higher although we acknowledge that we have seen a very strong post-election rally in equity markets and with valuations stretched, we may see a period of stabilisation/volatility as financial markets digest the initial actions of Mr Trump, before further gains are seen. We also remain conscious of the potential for headline risk surrounding Donald Trump which adds another layer of uncertainty and the potential for volatility.

In Europe we remain of the view that until the full ramifications for the UK leaving the EU are known that a certain level of uncertainty will linger although a feeling of calm has entered the UK for now as the UK Prime Minister looks to trigger article 50 by the end of March. Across Europe, we are seeing improvements in economic data whilst growth and earnings expectations are increasing. 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 with elections in France on the horizon where the populist candidate is performing well. We remain of the view 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 2017 progresses. A quicker than expected interest rate path in the US could also weigh on risk appetite however and we continue to monitor expectations.

We remain of the view that equities should be positive over 2017 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 see limited value for 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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