

## January 2017

### 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

### Contact Details

Andrew Houghton

**T:** +44 207 259 3149

**E:** Andrew.Houghton@gibuk.com

**A:** One Knightsbridge  
London  
SW1X 7XS

## Macro Environment

In the US, data coming in is fairly strong and economic optimism is at multi-year highs. US final Q3 GDP growth was 3.5%, higher than initially expected. The job market continues to run close to full employment with jobseekers representing 4.7% of the labour force at year-end. The U6 unemployment rate stood at 9.2% at end-December. Financial markets have reacted strongly to the victory of Donald Trump in the US presidential election. The repricing has been mostly driven by evolving expectations about potential policy changes proclaimed by the incoming administration during its campaign. 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 and a well-capitalised banking system. The US economy seems to be on the right track with the market pricing in two to three interest rate hikes in 2017.

Theresa May will be announcing the government's Brexit plan before triggering Article 50 in March this year. The UK Supreme Court is yet to determine whether the government alone has the right to trigger article 50 or whether prior consultation with MP's is required. The EU's general standing on Brexit is that if the UK wants to keep access to the EU single market it has to adhere to its four fundamental freedoms including the controversial movement of labour.

The global economy in 2017 is likely to deliver better growth rate than in 2016. The IMF projects the global growth to stand at 3.1% in 2016 and to recover to 3.4% in 2017. Many emerging market economies will benefit from improving operating environment, strengthening commodity (oil) prices, better prospects from developed market activity, loosening emerging markets policy rates, etc. Historically, these factors have typically translated into periods of solid emerging markets growth. Brazil, Russia and Argentina are likely to return to growth in 2017. South Africa and Saudi Arabia should also deliver improving results. The Chinese economy is expected to grow at a more sustainable level exceeding 6%. India and Indonesia will maintain their dynamic momentum while Turkey and Mexico remain surrounded by uncertainty of primarily a political nature.

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. One of our key points of focus will be to what extent Mr. Trump will be able to implement his protectionist and damaging trade policies.

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.

Central banks are expected to be less accommodative in their monetary policies going forward. The Fed is likely to move ahead carefully with future interest rate increases in an effort to avoid excessive tightening of financial conditions by raising rates too quickly. Market participants expect between two to three 25bps rate hikes in 2017. The ECB could start tapering its QE programme by the end of 2017.

The oil price has received a boost from the recent OPEC deal. The members of the oil producers' cartel reached an agreement in November 2016 to lower the oil output by 1.2m barrels per day from global production, provided non-OPEC countries such as Russia contribute 600,000 bpd to the cut.

## What does this mean for the US dollar?

The current interest rate differential is in favour of the USD. In addition, the expectations of faster interest rate hikes in the US provide support for the USD. The strong dollar relative to the currencies of major trading partners has undermined the competitiveness of U.S.-produced goods in both foreign and domestic markets. The strong run of USD is likely to continue as long as the Fed remains in the tightening mode. However, after the US elections the dollar has appreciated too fast too soon, in our opinion. Consequently, we see a limited upside in the USD going forward.

## Bonds

Following the victory of Mr. Trump and given the solid footing of the US economy and the rising expectations of FED hikes, 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. This has led to the pull-back of yields across developed and emerging markets. 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 with spread getting slightly tighter recently.

It is our view that for investors seeking yield in fixed income assets, emerging markets 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 their historical lows.

The strengthening economic growth (coupled with OPEC members agreement) should be supportive of commodities and emerging markets hard currency fixed income as an asset class. This environment is likely to create good entry levels for investors in the emerging markets fixed income hard currency space.

## Equities

Equity markets ended the year in positive fashion with gains seen across the board on improving economic data and a sense of optimism towards the US president-elect. The US remained at the front of investors' minds during December as president-elect Mr Trump began to pick his office. As expected, he began by naming all pro-US, pro-business candidates which was seen as the first step in Mr Trump's campaign to promote domestic growth. Financial markets responded positively and seem willing to give Mr Trump the benefit of the doubt until he enters office at the very least. This helped push the S&P500 towards record highs with another gain of almost 2%. Over the year, the S&P500 advanced nearly 12%. European indices were also strong in local currency terms and helped push global equity benchmarks higher with the MSCI World advancing 2.4% over the month, taking the yearly gain to 7.5%.

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 we expect the incoming president to employ policies that promote domestic growth. We note that the market is pricing in two to three interest rate hikes in 2017, after December's 0.25% increase, but 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 potential for headline risk surrounding Donald Trump adds a 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 across Europe as a whole we are seeing improvements in underlying data. 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 2017 progresses. A quicker than expected interest rate path in the US could 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 emerging markets 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](mailto:investment.enquiries@gibuk.com)

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