2nd August 2016

Key Points:

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

Macro Environment

Despite Brexit, sluggish global growth and political uncertainty (in the US and Europe), there has been a strong rebound in global risk assets driven by abundant global liquidity and a search for yield.

Whilst Brexit is likely to have a significant impact on the UK economy (July composite PMI down at 47.5 vs 52.4 in June) and a moderate impact on the Eurozone economy, it is still too early to make any conclusions on the hit to global growth. Despite any potential implications for the UK, there has been a strong rebound to risk assets in the region, which are back to or higher than pre-Brexit levels (with the exception of FX which is still softer). In the UK, the expectations are that the BoE is likely to ease policy via rate cuts and some credit easing measures to help support the economy from Brexit, while the ECB and BoJ are expected to accelerate their bond purchasing programme. Despite such expectations, the July central bank policy meetings surprised financial markets with all three central banks choosing not to make any material changes. In parallel Japan's cabinet approved YEN 13.5 trillion (USD 132 billion) of fiscal measures, which are expected to push up real GDP in the short term.

Less of a surprise was that policy was left unchanged at the latest FOMC meeting and the Fed did not provide any signal of an imminent rate hike. The initial expectation (prior to Brexit vote) had been that the Fed could raise rates twice this year however many economists now say that, given the increased global uncertainty, a rate hike is off the table for the rest of the year.

Helping to keep US treasuries anchored is US growth, which has been sluggish in H1 with disappointing Q2 GDP (+1.2% actual vs +2.5% survey) and downward revisions to Q1. Q2 GDP was impacted by significant declines in inventories as corporates chose to run down inventories rather than increase capital expenditure at a time when corporate earnings are sluggish. As we have mentioned before, the US recovery is irregular and we have seen this cyclicality of softer H1 GDP in previous years. Looking ahead, there are signs the economy could improve in H2. Unemployment remains at its lowest levels since 2008 (unemployment rate at 4.9%) and the recent firming in wages is consistent with a high level of labour utilization, which in turn has supported the recent uptick in household spending.

If Brexit is a contained risk, the FED and investors will start to focus on US macroeconomic data – primarily unemployment and inflation. Today, the Fed is basically meeting both of its mandates – low unemployment and underlying inflation rates (core CPI) averaged around 2%.

It is worth pointing out that the last rate hike in the US started in June 2004 when U6 underemployment was at 9.5% (currently at 9.6%). We continue to believe FED monetary policy will remain accommodative and gradual for the foreseeable future. This is a benign environment for risky assets. However, if for any reason US growth is much stronger or much weaker than expected, risky assets will have a more challenging time ahead.

Turning to China, we are of the opinion that the economy is facing lower and more sustainable growth levels going forward as opposed to a hard landing and that the authorities will remain supportive in a targeted manner, weighing continued support and rebalancing measures. This improvement in fundamentals is supported by the increased demand for metals which have seen a small recovery in H1 (copper marginally up +1.2% m-o-m, +2.8% in H1). That said the recent price action in commodities is mixed as crude oil has performed poorly (WTI -13.9% m-o-m).

Absent any major financial market shocks, which are difficult to foresee at this moment in time, we could see the market grind higher. This tepid risk-on environment and 'lower-for-longer' rates view adopted by the market have put the spotlight on EM as a potential winner in the Brexit aftermath. With nominal US treasury yields just a few basis points off the lowest levels in decades, the global 'search for yield' continues. For investors seeking yield in fixed income assets, EM credit (cash USD-denominated bonds) offers attractive yields (or spread over US treasuries).

What does this mean for the US dollar?

The effect of Brexit was clear in the safe heaven currencies with the USD strengthening and the Japanese Yen following suit. In addition to such a risk off scenario, the USD would also be set to benefit if a more hawkish Fed returned given improving fundamentals in the US.

The value of the USD is a fragile equilibrium of interests going forward. In the political landscape of power, a stronger USD does not benefit two of the 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

In the short term we expect the Fed to delay any interest hike and wait to see if there is any unforeseen risk coming from the unexpected decision by the UK to leave the EU. We still consider the labour market to represent the key variable influencing the Fed's behaviour going forward. Labour income appears resilient, household saving rates are healthier, US corporates have strong

balance sheets, the banking system is recovering and local financial conditions remain accommodative.

The yield in the 10 year US treasury tightened to 1.35% at the beginning of July before widening 10bps to 1.45% at the end of the month. The 10 year German bund yield slipped further into negative territory and hit an all-time low at -0.19% before ending the month at -0.12%. At current yields, European bonds, like Japanese bonds, offer no value to investors.

We need to look at the valuations of US treasury on a relative basis. G3 central banks are likely to maintain their accommodative monetary policies (some with negative nominal rates). In the case of developed economies almost USD 11.7trn of sovereign debt is trading at negative yields now. The US interest rate levels and slope of the curve fails to reflect fundamental valuations but are effected by the yield of other G7 economies. This could keep US rates anchored at lower levels than they should be.

With a spread level of 368bps over US Treasuries, you can make the case that EM fixed income remains attractive to large institutional pension funds and insurance companies that are searching for yields in an environment of negative G3 rates or very low yields in general. Especially given we expect better growth prospects for emerging markets compared to developed economies as oil prices stabilise and adjustments are made to current account imbalances.

Equities

The decision by the UK voters to leave the European Union came as a surprise to both us and the rest of the investment community in June but once that initial shock subsided; financial markets enjoyed a prolonged period of risk appetite in July. Financial markets were remarkably calm over the month as central banks remained vocal and made it clear that further stimulus is there as and when required, although both the BoE and ECB met during July and kept policy unchanged citing that it was too early to judge the effects of Brexit. Equity markets benefitted significantly from the risk appetite with various local indices posting their strongest returns this year whilst the S&P 500 index touched new record highs. The UK equity index continued its surge over the month with both the FTSE 100 & 250 recovering the losses incurred immediately after the EU referendum. Along with supportive central banks we saw the earnings season help drive sentiment with more positive than negative surprises across most sectors although the energy sector remains weak.

We still think the US recovery continues with improving economic data and accommodative monetary policy helping equity markets to steadily grind higher. In Europe the picture is less clear as the full ramifications for the UK leaving the EU are unknown but what is known is that both the Bank of England and the European Central Bank will do all within their powers to support their respective economies. We feel that any negotiations surrounding Brexit will continue to be well communicated and this should stabilise financial markets. In the short term however, we expect increased volatility surrounding UK economic data and UK assets.

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**

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