Viewpoint

GiB

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Key Themes for the next 3-6 months

- US FED may start interest normalization process sooner rather than later.
- Prospect of tighter monetary policy in Europe.

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Political and Macro Environment

Since Q3 2016 the world economy has experienced growth in all regions. G3 economies have been performing relatively well with the US being the laggard. Major EM economies are displaying positive dynamics with China exceeding expectations. The IMF forecasts 2017 global growth to amount to 3.5%, an increase from 3.1% achieved in 2016.

Positive trends support the global economic outlook for 2017 with risks to the outlook seeming relatively balanced. The economic recovery is gradually gaining momentum fuelled by improving global demand and strengthening labour markets, particularly in the developed world. In addition, except for the US, the world's leading economies are likely to maintain their accommodative monetary policies this year and governments are expected to support economic activity with fiscal stimulus.

Focusing in on the US, the economy keeps delivering relatively soft results in 2017. Whilst employment reports indicate reasonable hiring levels, other recent indicators in areas like wages, consumer spending, construction and auto sales have been decidedly less robust. As a result, economic forecasters have been busy adjusting their growth estimates for the economy.

The FED expects real GDP to grow 2.1% to 2.2% in 2017, compared to its previous outlook of 2.0% to 2.2%. Moreover, it expects the unemployment rate to fall to 4.2 to 4.3% this year, down from its previous projection of 4.5% to 4.6%.

The FED's actions and policies have represented the main market driver in 2017. On 14 June, the FED raised short-term interest rates for the second time in 2017, a move that was widely expected. The FED also said it would reduce its USD4.2 trillion balance sheet and taper its purchases of longer-term government bonds (though it didn't say how fast), bringing to an end the quantitative easing it undertook post financial crisis.

In Europe, Draghi's speech at the ECB's conference in Sintra suggested that the economic recovery in Europe is gaining momentum which will allow the ECB to gradually reduce their monthly purchases. Draghi also noted that "the past period of low inflation is…on the whole temporary."

The prospect of tighter monetary policy in Europe combined with the FED's actions has sent bond prices lower.

Commodities remained under pressure

The pressure on many commodities prices continued in June. Energy prices declined 6.4% during the month, driven primarily by a 7.3% slide in WTI whilst natural gas was down 3.5%.

Metals and minerals prices receded 0.7%, mostly due to a 7.8% fall in iron ore. June was the fourth consecutive month of declining prices of metals. Precious metals gained 1.1%.

What does this mean for the US Dollar?

During H1 2017, the US Dollar (as represented by the US Dollar Index) has weakened driven by the lack of implementation on President Trump's economic policies.

Looking forward, the FED monetary policy cycle and the geopolitical uncertainties in other countries could provide support for the US Dollar.

Fixed Income

June was a month where monetary policy was ratified and slightly changed by the FED and the ECB respectively.
During the first part of the year the FED has dictated the tempo of hikes/monetary policy, acting sooner than investors' expected at the beginning of the year. The first rate hike came in March after which the FED communicated that it will start reducing the balance sheet this year. Whilst the June FED interest rate hike was expected, the 10-30yrs slope flattened sharply by 14bps to 52bps (a level not seen since December 2008) as the FED tone turned more hawkish. In Europe, the ECB president Mr Draghi has opened the door for a potential change in monetary policy. Bunds reacted to Draghi's comments, with yields widening 16bps to 0.46%.

We expect one more interest rate hike in the US this year and the 10-year US note to trade within the 2.30% - 2.60% range with the possibility of breaking the upper range of the band towards year-end. This is on the back of further gradual normalization by the FED, which could start unwinding the USD4.5 trillion balance sheet by year-end. In Europe the ECB could commence the tapering process sooner rather than later. Our view remains that G7 Government bonds offer no significant value at current yields levels given the gradual changes in monetary policy.

This rate environment has had a limited effect on emerging markets assets with the EMBI GD posting a marginally negative return for the first time this year. This modest decline in EM hard currency took place despite the negative returns of commodities. The technicals remain strong with non-EM traditional investors continuing to allocate funds to the asset class.

Equities

Equity markets came under pressure in June as central banks began to hint at a tightening of monetary policy whilst the UK Prime Minister Theresa's May plans to increase her powers in Westminster by calling a snap election fell flat. Indeed, various central banks including the Canadian, ECB and BOE all intimidated that the time is approaching to withdraw some of the ultra-accommodative monetary policy that we have seen since the Great Financial Crisis. In the UK, the Prime Minister's decision to call a general election backfired after Mrs May ended with fewer seats in parliament and with an even bigger uphill task in negotiating Brexit as less seats will mean less chance of pushing through her own parties requirements.

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The increase in volatility and reduction in risk appetite weighed on risky assets and equity markets came under pressure. Banks were also in the spotlight with two regional Italian banks having to be bailed out by the Government who have ploughed and guaranteed billions of Euros whilst in the US, the strength of the banking system has seen banks announce large scale capital returns to shareholders in the form of share buybacks and dividends. The performance of the banking sector helped the S&P500 advance another 0.6% over the month and thereby bringing the year to date return to 9.3%. In Europe, positive returns were harder to come by as the superpower of Germany fell 2.3% whilst France and Italy declined 2.7% and 0.6% respectively. The UK equity market never enjoyed the general election outcome or the words of BoE governor Mark Carney who intimated that interest rate hikes may not be too far away as the FTSE declined 2.5% over the month. In Asia the weaker Yen helped drive the Nikkei up over 2% whilst gains were seen across the majority of the region.

We continue to acknowledge that we have seen an extremely strong rally in equity markets and valuations are currently rich as investors remain optimistic around global growth. Economic data remains positive across the globe and we have seen political risk recede slightly which is supporting optimism and thus we see no immediate reason for a significant pull back in equity markets. We expect equity markets to stabilise around current levels but remain cognizant of the potential impact of the removal of the accommodative monetary policy, despite economies being healthier than at any time over the last few years, and any complications around the UK's Brexit divorce.

We continue to believe that investors will keep on searching for yield and this should 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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