Viewpoint

June 2017

Key Themes for the next 3-6 months

- US FED may start interest normalization process sooner rather then later
- Escalation of tensions in the Middle East

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Political and Macro Environment

The US economy delivered relatively soft results in May 2017. The unemployment rate hit a 16-year low in May but the pace of hiring slowed as the economy added 138,000 jobs, well below the expected figure of at least 180,000. The level of unemployment as published by the Bureau of Labour Statistics had dropped to 4.3%, its lowest level since 2001. This makes the probability of a rate hike by the FED at its next meeting quite high.

Despite the fact that the number of new jobs created in May fell short of expectations, the US economy has been adding jobs for 80 months in a row now. However, the increase in job creation has not been accompanied by a corresponding growth in wages and the number of people in part-time work has remained high.

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 also displaying positive dynamics with China exceeding the 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 mostly 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 by fiscal spending.

The tensions in the Middle Eastern region have escalated as Saudi Arabia and three of its Arab allies cut diplomatic ties with Qatar, upset with what they see as the tiny emirate's tolerant attitude toward Iran and Islamist groups such as the Muslim Brotherhood. The moves by the KSA, Bahrain, the U.A.E. and Egypt came barely a week after US President Donald Trump visited the region and joined Saudi Arabia in lambasting Iran for sponsoring terrorism from Syria to Yemen.

Qatar is the largest exporter of liquefied natural gas in the world and the current political turmoil can have an impact on the energy prices.

Commodities remained under pressure

The pressure on many commodities prices continued in May. Energy commodity prices declined 4% during the month, driven primarily by a 4.3% slide in oil and an 11.7% drop in coal, according to the World Bank's Pink Sheet. Natural gas prices increased 1.6%.

Food prices advanced 2.4%, pushed up by gains in key grains (rice and wheat) and edible oils. Beverage prices receded 1% due to weak coffee prices. Fertilizer prices declined nearly 6%.

Metals and minerals prices receded 2.4%, mostly due an 11% fall in iron ore. Precious metals dropped 2.6%. May was the third consecutive month of declining prices of metals.

FED stays the course undisturbed by softer May 2017 data

The low unemployment rate and growing number of jobs suggest that FED is quite likely to go ahead and increase interest rates two more times this year in addition to the March 2017 hike. This could be followed by the divestment of USD4.5tn portfolio of bonds and other assets the FED had accumulated in an effort to keep rates low and revive the economy after the recession.

What does this mean for the US Dollar?

President Trump's economic policies, if implemented, have the potential to support the US Dollar and this is in an environment where the US has the best prospect for economic growth of all the G3 economies. The US Federal reserve monetary policy cycle and the geopolitical uncertainties in other countries could also provide support for the US Dollar. In May, US Dollar was weakening driven by the lack of US policy implementation and political turmoil.

Fixed Income

During May, developed countries bond markets did well. The 10-year US Treasury note led this performance, with its yield settling close to 2.20% by month end. The yield decline was driven by continuing stream of disappointing economic data from the US and the discussion of a possible impeachment of President Trump related to the testimony of former FBI chief Mr Comey.

In the May FOMC, the FED Committee pointed out that Q1 2017 GDP low growth level was likely to be transitory. The meeting minutes also mentioned a possible operational approach to reducing the System's securities holdings in a gradual and predictable manner. Under the proposed approach, the Committee would announce a set of gradually increasing caps, or limits, on the dollar amounts of Treasury and agency securities that would be allowed to run off each month, and only the amounts of securities repayments that exceeded the caps would be reinvested each month.

We expect 2 more interest rate hikes in the US this year and the 10-year US note to continue trading within the current 2.30%-2.60% range with 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.

Emerging markets remained well supported despite weakness in commodities (WTI -2.62% crude future July 17 and the CRB Commodity Index -1.07% during May). The technicals remain strong with non-EM traditional investors continuing to allocate funds to the asset class.

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Equities

Equity markets continued their strong start to 2017 with gains seen across the globe in May. The earnings season continued to surprise to the upside across the US and in Europe whilst the result of the French election, where Emmanuel Macron was victorious, also supported risk appetite.

The positivity drove equity markets higher with the S&P500 touching new highs when gaining 1.4% over the month whilst in Europe, gains were seen across all main regions. The Superpower of Germany advanced 1.4% whilst in France, equity markets gained 1.9%. In Greece equity markets rallied a further 8.8% whilst the UK had its strongest monthly return in 2017 when surging 4.9% over the month. In Asia, only Australia saw declines, -2.8%, whilst Japan and Hong Kong gained 2.4% and 4% respectively over the month. The positive regional returns ensured the MSCI World Index gained 2.1% over the month.

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 next attempt by President Trump to implement a policy change, elections in Europe or any complications around the UK's Brexit divorce including and/or the June Prime Minister elections.

We continue to believe that investors will keep on searching for yield within a low growth/return environment 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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