Market viewpoint

by Jose Canepa, Head of Asset Management

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Over the last two months we have highlighted that the collapse in commodity prices should support global growth by increasing households' discretionary income whilst pushing headline inflation further down, which could potentially lead the US monetary policy to be kept accommodative for longer.

February confirmed this overall picture. At the start of the month we received particularly strong employment numbers from the US with payrolls rising 257k in January in addition to strong revisions for the previous two months. Hourly earnings also rose +0.5%. On the inflation front CPI was down -0.7% in January although core inflation was +0.2% and +1.6% yoy and remains comfortably below the Fed's target of 2%. US Q4 GDP was revised down less than estimated to an annualised rate of 2.2% from the 2.6% previously announced.

We continue to believe that the US will drive global growth in the coming months but should only see inflation numbers gradually picking up over the medium term as lower commodity prices and USD strength influences start to dissipate. Core inflation and wage growth will remain key in influencing Fed behaviour.

As detailed previously the big policy update for the year was the QE announced by the ECB. The program is due to start in March. We continue to believe that QE, the boost from both a weaker EUR and lower commodity prices and the expected improvement in credit conditions will help fight deflation in the Eurozone and should spur economic growth in the region. Our expectations are that we will see this improvement in GDP by year end. However, with monetary policy at its limit, further structural reforms in peripheral Europe will be paramount in kicking off significant GDP growth. In the short term we acknowledge that solving the Greece problem will be a key risk event and will ensure an increase in volatility but our belief is that an agreement will be found after much brinkmanship.

We continue to see low yields within Europe as the anticipated QE continues to influence pricing. The US 10 year yield has risen to around 2.10% as our forecast for higher yields came to fruition over the last month. At the time our belief was that the pricing was factoring in a lot of negative factors and that once these fears were alleviated yields would rise. The freefall in Oil was a significant concern at the time but we have seen Oil bounce back recently to more sustainable levels, albeit it with continued volatility. The new Minsk agreement also took some of the Geopolitical risk out of the markets. Going forward our belief now is that US yields are at more sustainable levels but that the yield differential between the US and Europe will limit how much further US yields can rise.

Fed watch continues to be an important driver of markets. Yellen's testimony to Congress was a closely followed event with Yellen preparing the market for the dropping of "patient" in their forthcoming communication from the next FOMC meeting. Yellen downplayed the significance of dropping of "patient" in an effort to provide the Fed with sufficient flexibility to raise rates in June if necessary but more importantly allowing the Fed to delay the rate rise to later in the year. Our position remains the same with our expectation that there is a higher probability of a rate rise towards the end of the year. Our belief is that the Fed will raise rates but unlike previous cycles will be more patient as they allow the market to digest the tighter monetary policy.

What does this mean for the US dollar?

All ingredients are here to support the case for stronger US dollar over the medium term. Growth prospects are brighter in the US, the recent quantitative easing in Europe and Japan will continue to increase the interest rate gap between the US and the rest of the world and inflation expectations, on a relative basis, should continue to favour the US economy. In the short term, however, we acknowledge that the USD is overbought and that a short term pullback is a reasonable possibility.

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Bonds

We still believe that the Federal Reserve will hike rates during the second half of 2015. The Fed Chair Yellen gave a positive outlook for the labour market and the overall economy. The outlook for inflation remains subdued but the Fed could announced the first interest rate hike sooner rather than later but she left the door open for a more moderate forward guidance. Future economic data will be relevant to understand the "FED's judgement that conditions have improved to the point where it will soon be the case that a change in the target range could be warranted at any meeting".

In Europe the ECB has been the principal entity responsible for trying to stimulate growth. Yields are anchored at historical low levels and in some instances are at negative levels. Last week for the first time in history investors paid negative yields to invest in a 5 year German bond primary auction. The ECB's large scale asset purchase program should help stabilise the weaker economies but the responsibility to stimulate economic growth should rest with the individual governments for fiscal and structural reforms.

Taking into consideration the scenarios in the US and Europe, we maintain our call for flat to slightly negative returns for US rates but recognise that there is going to be a cap in US yields given the low levels of interest rates in Europe.

The recent weeks saw a change in risk appetite. Equities performed well and spreads more than absorbed the selloff in US rates. High yield securities in particular outperformed, supported by the low yield environment and cyclical inflows during the first months of the year. However, the HY sector however remains vulnerable to a fragile global growth and potential pull backs in market liquidity.

Emerging Markets spreads also compressed across the board. USD denominated indices performed well in February and HY components tightened for the first time since mid-2014. The energy/oil based economies also recovered some of their recent losses. The continuation of US Dollar strength however weighed on local indices which saw declines. Local market indices did not perform well however, suffering from the ongoing strength in USD. The price action is currently encouraging for the asset class (in particular in hard currency) and we continue to expect returns for 2015 to be around mid-single digit.

Equities

We remain optimistic on equity markets and expect to see positive returns over 2015.

We feel that the US will continue to drive global growth and thus equity returns. However, expectations of performance in the US will reduce if valuations start to become rich and if the dollar strength negatively impacts future earnings. European equities now show greater upside as corporate balance sheets strengthen due to lower energy costs, a weaker euro and an easing in credit conditions. As a result, we consider that exposure to European equities coupled with an FX hedge against further Euro weakness should outperform in the months to come.

We expect between 4-7% from global equities. There is potential for higher returns with prolonged accommodative monetary policy and low commodity prices however a severe slowdown in the US or an increase in geopolitical risks could increase volatility.

Asset Allocation

We are now at equal weight for bonds versus equities, and within bonds we remain allocated to EM debt via our EMOF product. Global bonds we believe will continue to offer low returns and exhibit limited upside, whereas

the positioning within our EMOF product should provide income with a chance of capital gains based on relatively short duration assets. We expect EMOF to deliver 4-6% over the coming 12 months, outperforming global bonds and credit.

Asset Class	Outlook	Positioning	Return Expectation (12 month)
Equities	Positive	Neutral on volatility grounds	4 – 7%
Global Bonds	Negative	Underweight	-2 – 0%
Emerging Market Bonds	Positive	Overweight	4 – 6%
USD	Positive	Neutral pending pullback	8% Vs Euro

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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