Market viewpoint

by the Asset Management team

Key Points:

- **Major central banks continue to move along different paths**
- **US Labour market strength shows no let-up so far in 2016**
- **Acceleration in core inflation contrasts with recent weakening in inflation expectations**
- **Higher Oil Prices and Chinese policy stimulus leave room for continued bounce in risk assets**
- **Money supply growing in Eurozone thanks to QE, but credit growth still slow**
- **'Brexit': uncertainty is the only certainty as far as the markets are concerned**

Macro Environment

The main investor concern at the beginning of the year was economic growth, in particular in China. Whilst fundamentals have remained relatively unchanged, it appears that investor concerns are easing somewhat.

In the US, there has been progress towards both Fed's inflation and employment targets since lift-off in December 2015. The unemployment rate has now reached the FOMC's estimate of the structural rate (4.9%) and core PCE inflation (1.67% YoY) has already surpassed the FOMC's year-end estimate (1.6%). Our expectation is that the Fed policy will continue to be dictated by a number of key data releases. Continued employment growth, a drop in U6 unemployment rate and an increase in wage inflation are key to Fed policy.

There continues to be disparity between the FOMC signals and market expectations regarding the future path for rates. The median of the FOMC dot plots chart (from Dec15) forecasts 100bps of gradual rate hikes in 2016 whilst a growing number of market participants do not expect any hikes during 2016. The FOMC forecasts a terminal rate of 3.5%, well above market expectations.

A number of foreign central banks have moved policy rates further into negative territory and in most cases this has led to lower borrowing rates and currency depreciation. However in some cases it has been a bearish indicator for risk assets, negatively impacting investor sentiment, who view negative rates as the last resort of central banks, subsequently leading to equity market declines. Whilst considering the implications of negative rates, we do not expect the FED to implement such measures in the US. The impact on money market funds in the US has been a key deterrent to negative rates in the past – given the larger role they play in financial intermediation. In a negative rate environment, retail deposits which account for one third of money market assets, could migrate to banks. Any resulting disruption of the commercial paper market could also have a perverse impact on the Fed's goal of expanding credit. However, devoid of any exogenous shocks, our base case continues to be that rates will remain unchanged in the very near term and the FED could possibly resume rate hikes later in the year.

Unlike the previous interest rate hike cycle, rate rises this time will be more gradual in order to allow the economy to continue to recover with monetary policy remaining accommodative for the foreseeable future. We see this scenario as the most probable, more benign for risky assets and currently NOT priced in by the markets. If for any reason US growth is much stronger or much weaker than expected, risky assets will have a more challenging time ahead.

Markets have turned their attention to Europe. Mario Draghi hinted that easing could be possible as “the ECB is ready to do its part” in making the euro area more resilient. A large part of the European markets' volatility has been down to broad concerns about the profitability of the region’s banks, the level of bad loans they have on their books and their ability to ride out further shocks. Furthermore, an EU summit paved the way for the announcement of a Brexit referendum. Polls have become much more equivocal in terms of whether the UK will ultimately leave the EU. The substantial uncertainty is likely to put pressure on markets.

There has been some support for commodity prices, driven by China’s moves to boost its economy, a drop in crude output from OPEC and the US, and a pledge by Saudi Arabia to limit market volatility. Brent was up nearly 6% on the month at 35.97 (vs .34 .74 in the previous month).

It is worth mentioning again that asset price volatility has increased given new regulation which has impacted financial institutions. This lack of secondary market liquidity will continue to amplify market movements (both positively and negatively) – this is true for all asset classes.

A few words on China

We are of the opinion that the Chinese 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. We appreciate that further revisions in FX policy will continue to impact investor sentiment and markets globally. It is worth noting that Chinese equity volatility will impact risk sentiment, though we do not expect the Chinese stock market correction to have a major impact on the real economy. The Chinese equity market is small relative to the size of the real economy, with a tradeable value equal to 1/3 of country’s GDP (for developed economies this ratio is around 100%).

What does this mean for the US dollar?

Our expectations of central bank policy divergence were again confirmed between the ECB becoming more dovish and the Fed in its hiking path. We expect this theme to continue into 2016 and provide the platform for a stronger US dollar over the medium term. Interest rate differentials should increase between the US and Europe (Japan) which will continue to favour the US Dollar. The EUR/USD may approach parity during 2016. We do acknowledge that a stronger USD is a headwind for the US economy and could influence Fed’s policy action. We note that the dynamics and technicals of the Yen are different and we have seen how this currency reacts to risk aversion during the first trading days of the year. Bank of Japan (BOJ) caught the market by surprise when it cut the deposit rate and brought it into a negative territory in an effort to return the country on the path of sustainable growth. In its statement BOJ mentioned the possibility of further interest rate cut if necessary. However the BOJ could have second thoughts given the impact on the currency and on interbank lending, which has almost stopped. It is worth noting, that even as risk sentiment improved towards the end of the month, the Yen did not react much.

Bonds

As we mentioned in our previous Asset Allocation minutes the future Fed actions are likely to be data driven to some extent. We consider the labour market to represent the key variable influencing the Fed's behaviour in the near future. 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 occasional headwinds mainly caused by the stronger USD have been partially offset by the fall in energy prices.

We expect the US treasury yields to be contained in terms of upside risk as marginally lower nominal yields in Europe will cap the upside in nominal yields in the US. During the month of February the yield on 10 year US treasury bonds declined to 1.73% from 1.92% reflecting concerns about the growth pattern of the US economy and general international backdrop.

The US will likely hike on the backdrop of a narrowing budget deficit, meaning the supply of treasuries will be reduced which should provide a good technical platform for these securities, whilst inflation expectations are well anchored. The BOJ decision to impose negative rates will also help to constrain the upward movement in US treasury yields.

This scenario is benign for equity and spread products. We also recognize that the continued weakness in commodity prices will not have the same impact on inflation as before, as the largest part of the price decline is already behind us. The US wage inflation trend is highly important with a stronger USD serving as a mitigating factor for inflationary pressures going forward.

Equities

In our previous meeting we acknowledged the market malaise and the negative impact upon equity markets and held firm in our view that equity markets would recover over the remainder of the year. Markets post our meeting retrenched further with MSCI World down over 11% year to date in mid-February, however we didn't have to wait too long for a recovery as equity markets charged higher recovering 6-7% from their lows.

We continue to believe that current market expectations of positive growth in the US over the year and an improving European GDP outlook, supported by accommodative monetary policy, should be positive for future equity returns for the remainder of the year.

In the US, we expect to see markets navigate a weak Q1 and eventually post positive gains over the remainder of 2016 as earnings growth concerns abate. European and Japanese equities should fare better in 2016 as lower energy costs, an improving money supply and weaker currencies positively impact corporate earnings.

Thus far in 2016 equity markets have seen significant volatility which we forecast to continue over the short term. We acknowledge the market's concerns but believe that the overall economic landscape hasn't changed significantly and certainly not enough to justify the negative markets seen thus far. Despite concerns surrounding commodities, emerging markets and China, we expect equities to recover and forecast that equities should grind back towards a flat year. We do however acknowledge that any surprise moves by central banks (not our base case) would affect risk appetite and thus equity returns. We believe any impacts will be more short term in nature and that the continuing search for yield within a low growth/return environment 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. We expect the G7 bonds to continue to offer low returns and exhibit limited upside, whereas the positioning of our EMOF product should provide income with a chance of capital gains based on a relatively short duration of 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**