Viewpoint

GiB

March 2017

Key Themes for the next 3-6 months

- The FOMC increases the interest rate with more hikes expected in 2017
- A number of European countries are facing a challenging year with elections coming up
- Central banks' monetary policy is less clear with the potential for slightly less accommodative measures, especially in the US

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Macro Environment

The FOMC raised the federal funds rate to a target range of 0.75% to 1.00%. The FOMC said it still envisions raising rates "gradually," when data shows the economy continuing to advance towards full employment and price stability but made a slight tweak to its forward guidance.

The Committee's view that three hikes would likely be appropriate in both 2017 and 2018 was not changed. The FOMC now expects the fed funds rate to hit 3%, their estimate of its long-run average, by the end of 2019. The key message from FED's chair Janet Yellen is that rates will continue their upward movement at a cautious pace.

According to Yellen the US economy is improving as evidenced by a wide range of indicators. This made it possible for the interest rate setting committee to continue pushing rates back to historically more normal levels.

However, the economic data has been mixed recently. The US GDP growth was modest in Q4 2016 and expectations for Q1 2017 are also weakening. The Atlanta Fed reduced its estimate for Q1 2017 GDP to 0.9%. The unemployment rate has come back to pre-crisis levels but questions marks remain about the real amount of slack left in the job market as the participation rate starts to pick up.

That said, the foundations for economic growth have been there for some time, with solid consumer spending during the last year, business sentiment improving while the banking system is liquid and well capitalised. The financial conditions remain accommodative after the hike.

The US economy is healthier, investors' expectations have improved and one could argue that at this stage the economy does not need the extra stimulus of Trump's economic policies.

Our base case scenario is that the US treasury 10-year yield will be higher by year-end but it will remain below 3%. A number of forces are likely to maintain the yield anchored below 3%, like a potential delay in Mr. Trump's policies and the low yield environment in Europe/Japan.

Markets have priced in the majority of Mr. Trump's expected fiscal policies and tax reform into asset valuations. However, the timing of these reforms is becoming uncertain as Trump's plans are facing some resistance. There is a high probability that these reforms could be delayed, in particular the tax reform which is complex to formulate, review and implement.

Europe is facing a politically challenging year with elections coming up in France and Germany. In the Netherlands the Pro-European ruling Liberal Party led by Prime Minister Mark Rutte secured an election victory. The result of the Dutch elections was positive for markets. This represented a blow to the populist anti-establishment sentiments, which is gaining a growing support in many countries as evidenced by the Brexit vote in the UK and Trump victory in the US.

Public polls suggest that politicians such as France's Marine Le Pen are increasing their chances of winning power in coming months. Victories for parties such as Le Pen's Front National and the German AfD could trigger Brexit-style referendums, which might undermine the very foundations of the EU. Investors and political experts do not expect Ms. Le Pen to come on top in the second run of the French presidential elections. This scenario would be a surprise to markets, risk sentiment would be shaken and it could help to push bunds and US treasury yields lower.

What does this mean for the US dollar?

We have to recognise the US Dollar has appreciated significantly during the last two years, but believe this currency will remain well supported despite volatility potentially picking up going forward. Trump's economic policies have the potential to support the US Dollar and this is in an environment where the US has the best prospect of economic growth of the G3 economies. The US Federal Reserve monetary policy cycle and the political uncertainties in other countries could also provide support for the US Dollar.

Fixed Income

US treasuries traded strongly in February on the back of economic data which broadly met, but did not exceed expectations and the yield of the 10-year note touched the bottom of its post-election trading range at 2.31% after the release of "dovish" Fed minutes. In this environment, risk appetite ran high and spreads tightened across the board. The tone started to change somewhat after Fed board members started to talk up the possibility of rate hike in March, at a time when the market only assigned a 30% probability to this scenario. The Fed speech was very efficient and the market quickly repriced; with the shorter part of the curve mostly affected, and the 2-year note reached a new high at 1.37%. The 10-year note moved back to the upper end of its trading range, touching 2.62% before the announcement. The actual 25bps rate hike was accompanied by dovish comments from Chair Yellen and actually triggered a relief rally in the belly of the UST curve. The moves in European rate was different, with 2-year bunds relentlessly bid and reaching an historic low in yield at -0.95% whilst the yield in the 10-year note reached a 1-year high at 0.48%.

Going forward, our expectation for 2 to 3 extra hikes this year mean that we see the 10-year US note continuing to trade in a range - potentially slightly higher than the current 2.30%-2.60% range - but we struggle to see a sustained overshoot either on the downside or on the upside. The front end of the US curve looks more vulnerable at this point. This backdrop paints a positive picture for global spreads (in particular high yield) despite expensive valuations.

Under our base scenario for US rates, EM as an asset class looks attractive to global asset allocators who continue to search for yield. However, we continue to believe that a cautious and opportunistic approach is warranted at this point in order to navigate through potential market turbulences. In view of these technical and fundamental considerations, we believe value will be created and there are likely to be better entry levels for investors going forward.

Viewpoint

Equities

Financial markets continued to enjoy risk appetite in February and during the first part of March, with improving economic data and the Trump effect spurring risk assets. Mr. Trump began to find his feet in the White House and promised a ‘phenomenal’ tax plan which along with improvements in economic data has seen the continuation of risk appetite. Indeed, expectations around his pro-US, pro-business policies continue to grow and helped drive US equity markets to record highs in February. Over the month the S&P500 and Dow Jones both hit record highs whilst the MSCI World index gained 2.8%.

We believe that the US recovery continues as the economy nears the Federal Reserve’s dual mandate targets regarding inflation, which could temporarily overshoot, and employment and we expect Mr. Trump to employ policies that promote domestic growth. We note Mr. Trumps aggressive tax cut rhetoric, which could have a significant impact on economic activity and job creation in the US. This has been largely priced in by markets. As expected, March saw the third interest rate increase in a decade and 2 more hikes are priced in for this year although the message from the FED is rates will rise gradually. We do acknowledge the fact we have seen a very strong rally in equity markets post-election and with valuations now stretched, we may see a period of stabilisation/volatility as financial markets digest the initial actions of Mr. Trump, before further gains are seen. We also remain conscious of the potential for headline risk surrounding Mr. Trump which adds another layer of uncertainty and the potential for volatility.

In Europe we remain of the view that until the full ramifications for the UK leaving the EU are known that a certain level of uncertainty will remain and we are now beginning to see mixed economic data out of the UK. Levels of consumer spending in the UK, for so long a pillar of strength, is coming under pressure with retail sales slowing significantly. Across the rest of Europe the picture is a little brighter with improvements in economic data and an increase in growth and earnings expectations. We remain cognizant of the fact that investor’s concerns around European banks remain and the political landscape in the region could also impact sentiment with elections in France on the horizon where the populist candidate is performing well. We remain of the view that central banks remain a key driver of risk in equity markets although we feel that central banks could move to a slightly less accommodative stance as 2017 progresses. A quicker than expected interest rate path in the US could also weigh on risk appetite however and we continue to monitor expectations.

We remain of the view that equities should be positive over 2017 assuming a soft UK exit from the EU with limited further shocks to the financial system. We continue to believe that investors will keep on searching for yield within a low growth/return environment.

This would 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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