Market viewpoint

by Jose Canepa, Head of Asset Management

May 2015 update

Macro Environment

In recent weeks the US macroeconomics numbers have been mixed. At the beginning of May we had the April Non-farm payrolls +223K (expected +228k) but with 39k downward revisions from the previous two months. Unemployment was at 5.4% (previous 5.5%). April retails sales and core retail sales disappointed, both flat on the month (expected +0.2% and +0.5%). The Q1 real GDP was severely revised down to -0.7%, however, this was slightly better than the initial consensus of -0.9%. As specified in the Federal Open Market Committee (FOMC) minutes, members view the weakness in Q1 growth as caused by temporary factors. April pending home sales rose +3.4% (expected 0.9%), this is positive for home sales going forward; over the past year home sales rose 13.4%. The Core CPI rose firmly +0.3% (mom, expected +0.2%), the Core CPI YoY figure stands at +1.8% (expected+1.7%). In May the ISM Manufacturing index rose+52.8 (expected 52.0, April 51.5) indicating that the weakness in manufacturing is past its peak. Solid figures for construction spending report in April 2.2% (expected 0.8%).

Oil has recovered from the lows, however, oil savings have not translated into higher consumer spending. USD strength is affecting economic growth and will contribute to inflationary pressures. The USD has reached a twelve year high versus the JPY. The US dollar valuation could be an important factor for the US Federal reserve when it considers the timing of the first interest rate hike. The FED has to take into consideration also the actions of other central banks.

The market is assigning a slightly higher probability that in the September FOMC meeting the interest rate normalization process could start. As mentioned in the FOMC minutes most members prefer indicating that the timing of the first hike should be determined on a meeting by meeting basis rather than the Committee providing an explicit indication of the likely timing in a FOMC statement.

In the short term the main concern is Greece that up until today has not reached an agreement with Europe. Greece a has heavy redemption schedule in the coming months starting with the IMF payment during the first week on June. This will keep investors concerned as politics are difficult to predict. Mr. Coeur ECB executive board member said that the ECB would frontload the QE now to avoid the lower market liquidity in July and August. This had a clear impact on the EURUSD but positive expectations related to a Greece deal approaching largely offset the EUR weakening. European policy makers also need to take into account the recent Spanish municipal and autonomous region elections results because they cannot afford to set a precedent.

Chinese authorities and Peoples Bank of China (PBoC) are working hard with consecutive interest rates cuts and supplementary lending to make sure this year GDP is on target. It is a difficult and complex process trying to rebalance the economy. There might be a slight downside risk in the GDP growth forecast for the year.

We continue to believe that the US, in line with previous years, will bounce back from a weak Q1 and lead the growth in the developed world. We should see inflation numbers gradually picking up over the medium term as lower commodity prices and the USD strength impact start to dissipate. Core inflation and wage growth will remain key indicators influencing the Fed behaviour.

Our view remains unchanged and we still allocate a higher probability of a rate rise towards the end of the year. Our belief is that the Fed will raise rates in 2015, Fed Chair Mrs Yellen has expressed willingness to raise interest rates this year. Given the unprecedented experience and the characteristic of the US recovery we believe that unlike previous interest hiking cycles this one will be more gradual and patient in order to allowed economic growth to consolidate.

What does this mean for the US dollar?

We continue to believe that all ingredients are here to support the case for a stronger US dollar over the medium term. Growth prospects continue to be brighter in the US, the recent quantitative easing in Europe and Japan should continue to increase or at least maintain the interest rate differential between the US and the rest of the world. The latter coupled with inflation expectations, on a relative basis, continue to favour the US economy.

We note that the Yen is subject to different dynamics to the Euro and also acknowledge that being long US dollar is market consensus. We have recognized the substantial QE and the impact on the currency but there is a limit where policy makers will get concerned about the pace and the level of depreciation.

Bonds

Given the recent data we acknowledge that the recovery is not totally smooth with some data coming on the weak side. We still believe the US economy will improve in the coming quarters. Household saving rates are healthier, labour income is good, US corporations have strong balance sheets and local financial conditions remain accommodative. There is some headwind with a stronger USD that partially has been neutralized with the fall in energy prices (not the case recently).

The market expectations have been adjusting for the potential first interest rate hike later in the year more in tune with our base case scenario. The FED needs to see that inflation will return to an acceptable level and the last core CPI print points in that direction. We have had strong USD and a good recovery in energy prices recently. This coming May payroll has the potential to be strong as indicated by preliminary data releases. The FED will start to normalize rates from an extremely low level and in a gradual manner to avoid any negative knock on effect in the economic recovery process.

In Europe it is important to point out the reversal in the valuation of the 10yr Bunds. This was largely driven by the mix of economic data coming from Europe, e.g. core CPI YoY 0.9% (expected 0.7%) and also by speculation regarding a potential agreement with Greece (not confirmed at the moment of writing). On the back of this news the 10yr Bunds YTM widened 17bps with other European bond markets following the bunds. The EURO strengthened sharply versus the USD (we maintain our view on USD strength). It is important to point out that these are some of the most liquid markets. We highlight this because we believe that this type of price action has been the result in part of the limited liquidity affecting financial markets.

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 nominal interest rates in Europe. We note that if nominal yields in Europe increase the cap for US Treasury could be higher.
The May performance of emerging markets indices was mixed. The EMBIGD was down -0.39%, with the index spread over treasury widening +6bps. It's not a surprise that on the background of the US

Treasury price action the IG component of the index accounted for the majority of this negative return -0.55% and the HY component detracted -0.15%. In the case of the CEMBI BD this index returned positively on the month +0.52%, all the performance was attributed to the HY component of this index. (CEMBI BD tightened -6bps). Both indices absorbed the US Treasury volatility well in comparison to previous occasions, in particular the corporate index.

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In a context of mixed performance for EM fixed income in May, the key highlight was the tightening of High Yield Corporate spreads (as represented by the HY component of the CEMBI index), which fell 17bps during the month to 535bps.
Although HY corporate spreads are not at historical lows in absolute terms (they reached 439bps in July 2014), the rapid tightening since mid-January's highs (679bps on January 15th) and the lack of pick up over US HY spreads make them vulnerable to external shocks, like a pullback in oil prices.

Elsewhere spreads were broadly unchanged in the month, with corporates marginally outperforming sovereigns and HY outperforming IG.

Equities

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

We continue to believe that the current market environment with positive US GDP in the coming quarters and an improving European GDP outlook should be positive for future 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. We see greater upside in European equities as corporate balance sheets strengthen due to lower energy costs, a weaker euro and an easing in credit conditions which should allow corporate to deliver increased earnings. 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 in 2015. 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 close to 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% in 2015, outperforming global bonds and credit.

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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